DISSERTATION

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Commercial Power Centers in Indonesia

A New Paradigm to Analyze the Role of Business Groups in Policy Making

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RGSD -144

RAND Graduate School

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Published 1999 by RAND
1700 Main Street, P.O. Box 2138, Santa Monica, CA 90407-2138
1333 H St., N.W., Washington, D.C. 20005-4707
RAND URL: http://www.rand.org/
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PREFACE

This study presents an analytical framework to view, and a methodology to assess, policymaking in emerging market economies. This view and assessment are clearer by using a new lens: the analysis of the political activities of so-called commercial power centers (CPCs)—i.e., their role and influence on economic policy. To illustrate the methodology, the framework is applied to Indonesia.

The analytical approach is multi-disciplinary and uses economic, historical, and case study analysis to derive key findings. The study should be of interest to decision makers and analysts in government and the private sector, as well as to scholars concerned with the dynamics of change and development in Indonesia and, more broadly, in emerging market economies.

The study is submitted as a dissertation to the RAND Graduate School, in partial fulfillment of the requirements for the degree of Doctor of Philosophy in Policy Analysis. It is a follow-on of work performed at RAND in 1997 on the subject, within RAND's national Security Research Division (NSRD), which does work for the U.S. Department of Defense, for other U.S. government agencies, and for other sponsoring institutions.

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SUMMARY

Crony capitalism and cozy relations between governments and local business groups have been widely considered as the root cause for the crisis that has swept East Asia in the second half of 1997, leading to the demise of Asia's longest serving president, President Suharto. Prior to the onset of the crisis, several policy analysts and observers of emerging market economies had underscored the increasing influence of large business groups on policymaking in these countries. This study seeks to address these issues by providing an integrated framework of analysis to understand and assess the role and influence of commercial power centers (CPCs)—on economic policymaking. We define CPCs as:

> Any group, combination, or coalition of large aggregate size, that seeks to influence the design and implementation of government economic policies to suit its diversified economic interests.

The analytical approach is three-pronged: (1) describing and critiquing literature on interest groups, collective action, and economic regulation to develop a model describing the behavioral characteristics of CPCs placed in a quasi-market for political influence on economic policymaking; (2) employing historical analogies appropriate for understanding today's emerging market economies; (3) applying the model to Indonesia to add texture to the analysis and illustrate its usefulness.

In the theoretical section, we rely on existing literature and models to describe and formalize the role and activities of CPCs, as well as their influence on policymaking. We place CPCs in a quasi-market for political influence on economic policy. The quasi-market is used to trade instruments of economic policy such as economic regulation, taxes, and subsidies. CPCs are on the demand side of the market, whereas nonmarket actors and institutions are on the supply side.

We answer three key questions that describe the behavior and incentives of CPCs: why, what, and how to influence policymaking? CPCs engage in political activities because they want to capture economic rents—i.e., streams of revenues stemming from preferential economic policies or regulations that promote or protect CPCs' interests. CPCs seek to collectively influence policymaking out of shared interests and to increase their influence. They need to remain small to combat free-riding and maintain a high level of political effectiveness. Finally, CPCs use various channels of influence to access policymakers. These channels range from personal contacts (including bribery) to institutional channels (e.g., lobbying Members of Parliament).

Our preferred model for describing and assessing the role and influence of CPCs on economic policy was developed in 1983 and 1985 by Chicago economist Gary Becker. Becker derives his key propositions using a *logic of deadweight costs* which highlights the *intrinsic advantage* of taxpayers (relative to the recipients of subsidies) in the policy process. Because it is based on relative prices (of taxes and subsidies), the model does not require a given form of government, nor does it resort to social welfare functions or to the notion of a benevolent state to derive its results.

Becker's model is iconoclastic as it suggests that the activities of CPCs are conducive to *more efficient* outcomes in the selection of policies—i.e., policies that are selected through the quasi-market for political influence are more efficient than those that would be selected without the competition among CPCs. This result contrasts sharply with the results from the literature on economic regulation, which sees the political activities of pressure groups (e.g., trade or general business associations) as essentially distortionary and inefficient (by promoting preferential and inefficient policies).

The result according to which the quasi-market yields relatively more efficient policy outcomes is predicated, however, on a quasi-market where transaction costs are nil. This can be best achieved through competition and free entry in the quasi-market. The more competitive and open the quasi-market, the more efficient the policy outcomes. Conversely, if the quasi-market is not competitive and is closed to entry of new CPCs, then CPC activities can be perverse and counterproductive.

After the theoretical section, historical analogies of the early development of western capitalism are used to derive insights that are applicable to today's emerging

markets. This historical excursion traces the evolution of the role and influence of merchant guilds on local rulers during the medieval commercial revolution (11th-14th century), the constitutional crisis of the early 14th century between the English King and Parliament over regulation of wool trade, and the economic policies of Elizabeth I, the last Tudor, in the 16th century.

The slow historical progression from a situation of one CPC vs. one ruler to one of several CPCs facing multiple government institutions illustrates the challenges involved with the development of market capitalism. Not only are markets imperfect, but so are nonmarkets (i.e., government institutions). The chapter highlights the crucial role played by CPCs in economic development. CPCs seek to address and sometimes internalize market failures, and exert considerable political pressure to obtain and shape nonmarket institutions that are conducive to their prosperity. In this perspective, Parliaments and courts of law are the stepchildren of CPCs.

Finally, we apply the framework to Indonesia. The methodology is used to carry out the analysis of Indonesian CPCs. The case study defines, describes, analyzes, and assesses the role and influence of CPCs in Indonesia. We confine the group of active CPCs to four: the large Sino-Indonesian conglomerates, state-owned enterprises (SOEs), the Suharto family, and the non-oil and gas foreign sector. We consider the military as a *hesitant* CPC that has a general interest in economic policy, but no vested commercial interests that it would seek to promote and protect. We also point toward the emergence of an indigenous Indonesian CPC, which may grow in importance in the post-Suharto era.

The case then illustrates the CPC methodology by articulating CPCs' interests with respect to four policies at the core of the various IMF reform packages: banking supervision, SOE privatization, trade liberalization, and investment deregulation. The analysis graphically shows how, given the opposition of domestic CPCs to reform, it was virtually impossible for Suharto to implement the various reform measures agreed upon with the IMF in 1997-1998.

To guide the research, we evaluate four propositions that illuminate the key questions surrounding the issue of the rise to prominence of business actors in economic policymaking in today's emerging market economies. The propositions are evaluated using the three analytical approaches this study relies upon.

First, *the development of CPCs is a typical and normal phenomenon associated with the development of a market capitalist system; it is not aberrant, exceptional, or surprising.* Both the theoretical models, the historical analogies, and the case study underscore the normalcy and logic of CPC activities, which accompany the development of a market economy. Gary Becker's model highlights the crucial role played by nonmarket institutions in allowing the quasi-market for political influence to function properly and generate less inefficient policy outcomes—relative to the myriad of policies that are not enacted due to pressure from interest groups. The historical analogies also underline the importance of the parallel development of nonmarket institutions and, in particular, of the role of the judiciary in providing durability and permanence to laws and regulations.

Second, *the activities and policy influence of CPCs tend to grow as market capitalism develops. However, this growth may not be monotonic. As the number of CPCs increases, the result of their mutually countervailing effects may diminish their net influence.* The historical analogies and the case study reveal clearly that, as a market economy develops, the number and influence of CPCs tend to grow. The net result of their influence is indeed lower than the aggregate sum of their influence would suggest, because of the conflicting interests CPCs pursue. The case study also reveals that the quasi-market for political influence may be monopolized by powerful CPCs and entry into the market may be impossible, or require payment of rents to existing CPCs. In the extreme, one CPC could become a perfect monopoly (i.e., the only one in the quasi-market) and receive all the subsidies that the state hands out. The monopolization and entry restriction into the quasi-market vitiate the beneficial aspects (more efficient policy outcomes) of bringing competing interests into a political market for influence.

Third, *the influence CPCs exert on policy can be (and sometimes has been) beneficial and healthy, and sometimes perverse and counterproductive.* To reiterate, according to the chosen theoretical model (Gary Becker's), the activities of CPCs are conducive to more efficient outcomes in the selection of policies if the quasi-market is characterized by competition and free entry. The historical analogies highlight the relativity of normative judgments about the role and influence of CPCs. CPC activities can be both positive and negative, depending on one's standpoint. The dual role of guilds in monopoly creation and trade expansion during the high Middle Ages highlights this

fact. Although monopoly creation is efficiency-reducing and, as such, is negative, trade expansion constitutes a positive contribution of CPCs to their local economy. The evolution over time of guilds, from trade facilitators (in the Middle Ages) to free market inhibitors (in the mercantile era), highlights the danger of intertemporal normative observations.

Applied to the case of Indonesia, the case study reveals the role and importance of CPCs in the development of Suharto's so-called New Order. They have been instrumental in the process of capital accumulation and investment that has propelled Indonesia from a poor country in 1966 to a showcase of economic prosperity and stability until July 1997. At the same time, the political crisis that resulted has highlighted the perverse and counterproductive activities of Indonesian CPCs—chiefly of the Suharto family—when the quasi-market is monopolized and entry is restricted. These CPCs used their monopolistic position in the quasi-market to obtain most of the subsidies handed out by the state. In Indonesia, the perverse activities of CPCs led to the virtual paralysis of all economic activity due to the standoff between President Suharto and the IMF, which stemmed mainly from the pressure exerted by CPCs on the President.

Given that the above three propositions are validated, the fourth one is almost tautological: *In understanding policymaking and policy implementation in emerging market economies, the role and influence of CPCs should be accorded prominent attention.* Theoretical models, historical analogies, and the case study all highlight the importance of according prominent attention to the role and influence of CPCs in trying to understand policymaking in today's emerging market economies.

From a general standpoint, two key policy implications derive from the analysis. First, a *healthy—competitive—quasi-market for political influence is a prerequisite for the development of market capitalism.* Multiple institutions are important in fostering economic development. CPCs, which can be viewed as the NGOs of the private sector, are very important institutions in fostering market capitalism. International lending institutions and development agencies have placed much emphasis on the development of institutions on the supply side of the quasi-market for political influence. As much effort ought to be placed in monitoring and promoting the establishment and development of trade associations, professional organizations, and other types of business representation. Without such institutions,

emerging markets are too frail to survive the profound economic and social shocks that characterize the developmental process.

Second, a *healthy—competitive—quasi-market for political influence is a prerequisite for the development of democracy and parliamentary life.* On the supply side, it requires the institutions long called for by institutional economists, such as functioning court system, enforceable bankruptcy laws, or efficient customs operations. On the demand side, it requires a healthy demand side of the quasi-market, composed of multiple and competing CPCs. Competition among CPCs allows for compromises that are consistent with the prevailing local market conditions. Rather than imposing pre-made institutional mechanisms, it is preferable to let the local quasi-market for political influence decide policy trade-offs and priorities.

The CPC methodology is closer to an art than to a science. It requires a great deal of judgment and in-depth knowledge of a country's institutions, history, and other relevant factors. Yet, even to the country expert, the results of the analysis are quite powerful and intriguing (e.g., more efficient policy outcomes generated by CPC competition). The case study, as well as other work done by the author and RAND colleagues using the CPC framework, show that the usefulness of the analysis is high and that its applicability to other emerging market economies, including perhaps the transition economies of the former Soviet bloc, is broad.

ACKNOWLEDGMENTS

This dissertation is the continuation of the report I wrote in 1997 on Indonesian CPCs. I am grateful to the many people who helped then, to those who have reviewed my report subsequently, and to the many people who have helped me in completing the dissertation. At RAND, I owe a lot to my officemate, Daochi Tong, who has supported and encouraged me all along. I am also indebted to Jeremy Azrael and Rachel Swanger, who have reviewed my earlier report and provided useful comments and constructive criticism. Many thanks finally to C.R. Neu, who formally reviewed the earlier report and provided many insightful comments, which improved the overall quality of the report and, hence, of the dissertation.

Outside of RAND, I have received a great deal of help from Elena Mikalis, Indonesia and ASEAN Affairs Desk Officer at the U.S. Department of Commerce. Many thanks also to Smita Singh, a Ph.D. student at Harvard, as well as to Kimberly Niles, a Ph.D. student at UCLA, who provided me with a wealth of very valuable data and information. Guy Pauker, a former RAND analyst, has also reviewed my earlier report and provided very useful comments that substantially improved the case study.

The dissertation committee has supported my earlier efforts and extended support and encouragement for this dissertation. Charles Wolf, Jr., Gregory Treverton, and Ambassador Edward Masters, former Ambassador to Jakarta from 1977-1981, have helped me tremendously—from the first steps of the data collection to the final write-up. Jerrold Green has been the non-Indonesian and non-CPC specialist who has provided a healthy reality check of the CPC approach. His comments went a long way into turning interesting insights into a dissertation.

How not to conclude by mentioning my many friends and family who have provided me with most valuable moral support and helped boost my sometimes battered

confidence. My running partners, over countless miles, have helped me appreciate the good moments along the way. My tireless running coach, Laszło Tabori, has helped me discover the strength that lies in me. Last but not least, my wife, Janet, and my son, Eric, have been my inspiration every second of this endeavor. This thesis would not be if it were not for their incommensurate support, encouragement, and love.

As a dedication, this dissertation goes to Sébastien Kindembi, my long-time Zairian friend who first told me that I should and could complete a doctorate; to Georges Delcoigne, who helped and persuaded me to undertake graduate studies at the Johns Hopkins School of Advanced International Studies (SAIS); and to Jon Kathe, a SAIS alumnus and friend who insisted I pursue my dreams.

ACRONYMS AND GLOSSARY OF INDONESIAN TERMS

ABRI	Angkatan Bersenjata Republik Indonesia (Indonesian Armed Forces)
Ali-Baba	Quid-pro quo relationship of influence or protection (from people with political influence) for money or financing (from people with economic resources but no political influence)
ASEAN	Association of South East Asian Nations
Benteng	Import licensing system under the Old Order
BKPM	Badan Koordinasi Penanaman Modal (Capital Investment Coordinating Board)
BPIS	(Coordinating Agency for Strategic Industries)
CPC	Commercial Power Center
BPS	Biro Pusat Statistics (Indonesia's National Bureau of Statistics)
BULOG	Badan Urusan Logistik Nasional (National Logistics Board), in charge of purchase and price stabilization of staple food, like rice
CCCN	Customs Cooperation Council Nomenclature
cukong	Name given to major Sino-Indonesian businessmen, due to their role as financiers in ventures with leading figures from the state bureaucracy or the military (Ali-Baba system).
dwifungsi (dual function)	Principle of the dual role of the military in society: national defense and civil administration
FDI	Foreign Direct Investment
GDP	Gross Domestic Product
GOI	Government of Indonesia
Golkar	Golongan Karya ("Functional Groups"), ruling party
IBRA	Indonesian Banking Restructuring Agency
IFC	International Finance Corporation
IMF	International Monetary Fund
IPO	Initial Public Offering
JSX	Jakarta Stock Exchange
Kostrad	Komando Cadangan Strategis Angkatan Darat (Army Strategic Reserve Command)
LNG	Liquefied Natural Gas
MoU	Memorandum of Understanding
New Order	Indonesia under President Suharto's rule (as opposed to 'Old Order')

NTB	Non-tariff barriers
Old Order	Indonesia under President Sukarno's rule (as opposed to 'New Order')
Opsus	Operasi Khusus (Special Operations)
PDI	Indonesian Democratic Party
Pelita	Abbreviated form of Repelita
Peranakan	Sino-Indonesians arrived in Indonesia several generations ago
Perjan	Perusahaan Jawatan. One category of SOE -- Public service
Persero	Perusahaan Perseroan. One category of SOE -- Limited liability company
Pertamina	State-owned petroleum company
Perum	Perusahaan Umum. One type of SOE -- Public and commercial objectives
PMA	Penanaman Modal Asing (Legal Status for Foreign Investment)
PMDN	Penanaman Modal Dalam Negeri (Legal Status for Domestic Investment)
PPP	Purchasing Power Parity
Pribumi	Indigenous (*i.e.*, non-Sino-Indonesian) Indonesian
PT	Perseroan Terbatas (Limited liability company) Persero SOEs are PT companies
Repelita	Rencana Pembangunan Lima Tahum (Five-Year Development Plan) Follows Fiscal Year schedule (April 1–March 31)
Repelita I	1969/1970-1973/1974
Repelita II	1974/1975-1978/1979
Repelita III	1979/1980-1983/1984
Repelita IV	1984/1985-1988/1989
Repelita V	1989/1990-1993/1994
Repelita VI	1994/1995-1997/1998
Rp	Rupiah (Indonesian currency)
SOE	State-Owned Enterprise
TBD	Thousand Barrel per Day (measure of oil output)
Totok	Newly arrived (usually first-generation) Sino-Indonesians immigrants
Yayasan	Foundation

Chapter One

INTRODUCTION

BACKGROUND AND MOTIVATION

During the past decade, on the labels of sweatshirts and hi-fi systems, country names like Malaysia, China, Taiwan, Korea, and Indonesia have become commonplace. In corporate boardrooms and in management seminars, emerging markets have become a central element of any growth strategy. These so-called emerging market economies include countries as diverse as China and Chile, Turkey and Thailand. Whereas these countries were once viewed as faraway destinations for exotic trips, they are now part and parcel of the "global economy."

If the emergence of these countries has been sudden, the economic and institutional transformations required to propel them onto the international economic scene have been no less dramatic. Development strategies of several of these emerging market economies in the 1980s and 1990s has been centered on some type of economic liberalization.

Broadly speaking, this liberalization process is twofold, entailing deregulation and internationalization. The deregulation process is part of the transformation from a traditional economy to a market one. It attempts to substitute market forces for controlled, regulated economic and social relationships. Internationalization entails a dual process: the opening of the economy to attract foreign sources of capital and know-how, and increasing trade.

The liberalization process is akin to re-writing the rules of the economic game, and thus alters not only the structure of the economy and its agents, but also local politics and public decisionmaking. It creates winners and losers. At the same time, high economic growth provides further opportunities and challenges to various economic

groups. As a result, new actors emerge to exert influence on economic policy, whereas traditional actors (like state-owned enterprises, SOEs, or the military) lose some of their influence in the economy.

The 1997-1998 crisis in Asia, particularly in Indonesia, has revealed the existence and role of some of these new actors. In the case of Indonesia, the consensus until late 1997 was that the word of the government could be trusted. This was a country that had taken several painful steps from May to October of 1997 to protect itself from the spreading crisis that erupted in Thailand in July of that year. When the Indonesian government reached its first package of reform measures with the IMF in October, the markets applauded the efforts and the country's exchange rate (vis-à-vis the U.S. dollar) strengthened by 15 percent within a week.

Yet, this optimism was quickly replaced with deep pessimism when concerns about President Suharto's health were voiced in late 1997, underlying the crucial role the President plays in the stability of the country. How can the economy of a country as large and diverse as Indonesia, with a rich pool of highly trained economists and managers, be so dependent on the health of its aging president? When the first months of 1998 revealed how influential the members of the first family and a few business tycoons were, international investors started thinking that the stability of Suharto's regime could no longer be assumed. What made the Suharto regime so fragile?

Articles, editorials, and commentaries have been published daily on the causes and consequences of the economic turmoil that ravaged ASEAN economies in the second half of 1997. The crisis has been analyzed using various prisms or models—some focusing on the role of the central government, others on corruption, others on the role of international capital flows, and so on. In the case of Indonesia, the focus has been either on the burden of short-term borrowing from abroad (aggravated with the devaluation of the currency) or on corruption and cronyism, attributing most of the blame for current woes to the Suharto family and the President's close friends. Whereas until recently, Indonesia was a symbol of macroeconomic stability and a World Bank wunderkind, current reports of local cronyism and nepotism liken the country to the kleptocracies of Zaire and the like.

The reliance on cronyism and nepotism as an explanation for the Indonesian crisis is not satisfactory, nor is the reliance on other various single-lens prisms used by most observers. Such prisms fail to capture much of the texture of the new policymaking environment present in emerging markets—turning an intricate Indonesian batik design into a simple one-dimensional pattern.

Deregulation and internationalization have created a new environment and the policy process has become much more complex. The crisis that swept through Asia in 1997-1998 has shattered the old prisms.[1] A sole focus on the role of the military or of a few families, or on the size of current account balances, is too narrow and ill-focused to explain today's Indonesian crisis—and the same argument can be made about South Korea or Thailand.

A new model (or framework) is needed to improve the comprehension of economic policymaking in emerging markets. We focus in this study on the demand side of policymaking--i.e., the demands by commercial actors for favorable economic policy (e.g., preferential regulatory and tax treatment). The model provides an analytical framework to evaluate the role and influence of commercial actors on policymaking. We refer to these activities as *political,* as opposed to the economic/business activities in which these actors are engaged. The model provided here adapts, combines, and expands existing models. The endeavor can be placed in the larger context of trying to understand and model the respective roles of state and private market actors in policymaking in emerging market economies.

THE ACADEMIC DEBATE

Neoclassical vs. New Political Economy

The economic success of East Asian economies (until the 1997-1998 crisis at least) has been used by scholars from very diverse opinions as a showcase to demonstrate their vision of economic development. No theory of economic development would be credible if it could not account for the unprecedented growth in East Asia in the

[1] In candid retroactive assessments of the crisis, both the World Bank and the IMF recognized that they had not anticipated the depth of the crisis, nor correctly evaluated the obstacles in implementing structural reform, in particular of the corporate and financial sectors. See World Bank (1998) and, for the IMF, Lane et al. (1999).

past fifty years. Conflicting interpretations of the economic success of East Asia have revolved around the relative roles attributed to the state and private markets in fostering rapid growth.

The difficulty lies in determining when and under which conditions the state should intervene in the developmental process. Market failure is the key concept used to determine if a situation requires state intervention or not. Markets are said to fail when market mechanisms do not generate adequate price signals, and, hence, do not permit the most efficient allocation of resources—which, under ideal conditions, generates production efficiency.[2] To varying degrees, all scholars agree that the economies of developing countries are characterized by endemic market failure.[3]

Early development economists underscored the endemic market failures existing in developing countries, which made them different from developed economies. This approach to development is referred to as the structuralist school.[4] The role of government in developing countries thus extended beyond maintaining law and order and enforcing contracts. The government (organ of the benevolent state) had to act for the common good by correcting these market failures. It was supposed to selectively steer the economy in the direction of economic growth by channeling investment to preferred sectors of the economy. Two dimensions are worthy of attention: trade and entrepreneurship.

In terms of trade, Jagdish Bhagwati detected "export pessimism" among these early development writers. "Astonishingly," he said, "many major development economists were pessimistic about foreign trade opportunities."[5] Instead of using trade as a means to accelerate development, trade was seen as inherently disadvantageous to developing countries. These countries were encouraged to develop local industries, by protecting them from foreign competition. Raul Prebisch (1959) formalized the system referred to as the import substitution strategy.

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[2] The concept of market failure is discussed at length in the following chapter.

[3] See Bhagwati (1984).

[4] See P. Rosenstein-Rodan (1943), W. A. Lewis (1955), G. Myrdal (1957); A. Hirschman (1958); and R. Prebisch (1959). For a summary view, see H. Chenery (1975), and for retrospective assessments, see A. Hirschman (1981) and P. Rosenstein-Rodan (1984).

[5] Bhagwati (1984, p. 28).

In terms of entrepreneurship, research on the socio-cultural conditions associated with the emergence of entrepreneurship suggested, in the words of Nathaniel Leff: "pessimism concerning the prospects for less-developed countries generating sufficient entrepreneurship to achieve high rates of economic development."[6] This pessimism was epitomized by Albert Hirschman's focus on the "one basic scarcity"—economic entrepreneurship—as the starting point for any development strategy.[7]

This dual pessimism proved unfounded. First, export pessimism was unwarranted. A substantial body of evidence demonstrated that the cost of import substitution outweighed its benefits and that, to the contrary, export-led growth was the best path to development.[8] Second, pessimism concerning the rise of private entrepreneurs in developing countries proved unwarranted as well. Many developing countries experienced high growth rates in manufacturing—the one sector where entrepreneurship constraints were expected to be most severe—and economic growth involved successive development of new and more productive economic sectors—not only a uniform growth of the economy.[9]

In addition to the rebuttal of this dual pessimism, the other line of criticism of early development economists addressed the issue of market failure. Neoclassical economists argued that the failure of government in addressing and fixing market failures was as endemic, if not more prevalent, than market failures.[10] The consensus was that, regardless of the presence of market failures, there were, in the words of T. N. Srinivasan (1985), "colossal government failures" which significantly outweighed market failures. According to the neoclassical model, the government had to create an environment in which the private sector could prosper by making its own decisions. Individual entrepreneurs, it was thought, could better than any bureaucrat direct their resources to productive uses.[11]

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[6] Leff (1979, p. 46). For a bibliography and good discussion on the problems of entrepreneurship, see F. Derossi (1971) and P. Kilby (1971).

[7] See Hirschman (1958, pp. 24-28, 73).

[8] See for example, Little, Scitovsky, and Scott (1970), and Ann Krueger (1978).

[9] For a discussion, see Leff (1979), and Little, Scitovsky, and Scott (1970).

[10] See for example, Bauer (1976, 1984); Krueger (1990); Lal (1983); and Wolf (1982, 1993).

[11] For a discussion about the superior abilities of individual entrepreneurs, compared with bureaucrats, see for example, James, Naya and Meier (1989).

The economic success of East Asian countries, which started in the 1960s but only became apparent in the 1970s and 1980s, allowed neoclassical economists to fully debunk earlier theories of development. They argued that the successful East Asian development stemmed from the fact that the East Asian states had pursued policies consistent with neoclassical recommendations. With nuances, neoclassical economists claimed that these states facilitated development by letting private sector participants mobilize and allocate resources as they saw fit and by intervening in the market place only in cases of clearly established market failures such as the provision of education or public health.[12]

By the beginning of the 1980s, neoclassical political economy established itself as the dominant paradigm of economic development, especially with respect to the need to implement export-oriented growth strategies.[13] International lending institutions like the World Bank also espoused the paradigm's tenets. So did the OECD and the National Bureau of Economic Research (NBER), among others.[14]

A contrary view has been advanced by a diversified body of literature, loosely referred to as the "new political economy" [NPE].[15] According to the NPE, the successful East Asian economic development has to be attributed to the active role of the state in economic matters. Rather than guided by some invisible hand, private actors have reacted to incentives put in place by the state. In this view, government policies have been "market sustaining rather than market suppressing."[16]

One of the most salient critiques of neoclassical political economy is by Robert Wade. In his monograph, *Governing the Market* (1990), he reviewed Taiwan's policies of economic development. Prior to Wade's analysis, Taiwan was used by neoclassical economists as the best example of the successful application of their recommendations. Throughout the 1950s and until about 1958, the government followed an import-substitution strategy. In the 1958-1962 years, Taiwan changed course and

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[12]For a discussion of the tenets of neoclassical political economy, see Colander (1984) who coined the term neoclassical political economy, Chowdhury and Islam (1993), and Islam (1994).

[13]Robert Wade noted that, prior to his book, virtually all the economics literature about Taiwan came from the neoclassical side of the debate (Wade, 1990, p. 52).

[14]For a summary of theses various researches, see Krueger (1978) and Little, Scitovsky and Scott (1970) already cited, as well as Bhagwati (1978) and Balassa *et al.* (1982).

[15]The "new political economy" label was suggested by Chowdhury and Islam (1993) and appears to be the best characterization of that body of literature. See also, Islam (1994).

[16] Lim Youngil (as quoted in Johnson, 1987, p. 141).

established a free-trade regime, along with a freer labor market, high interest rates, and conservative public budgeting. Hence, Taiwan essentially embodied the key neoclassical policy recommendations. Within a few years, the Taiwanese economy improved dramatically.[17] Unsurprisingly, neoclassical economists argued that Taiwan's economic success was to be attributed to the adoption of economic policies in line with neoclassical policy recommendations. "There can be few such clear cases in economic history of cause and effect," said Little, Scitovsky, and Scott (1970).

According to Wade, however, Taiwan was successful, not because the government was minimalist and took a back seat approach in the development process but, to the contrary, because government policies had been carefully crafted so as to create incentives for private entrepreneurs to invest in desired sectors. For Wade and other proponents of the NPE, while market forces are important, government can and must play an active and decisive role in development.[18] In this perspective, the private sector is the engine of growth, but the government is its driver.

Despite the marked differences between the neoclassical and NPE schools of thought, they are much more similar to one another than they are to the structuralist school. In contrast to the latter, both schools recognize the central roles of trade and private sector entrepreneurship in development. What divides the neoclassical and the NPE schools is the extent of government intervention in the developmental process and whether the private sector can generate economic growth without extensive government intervention. Neither school advocates an extreme position: neoclassical economists do not call for a Smith-like minimal state (recognizing the particular challenges facing rapidly growing economies, and hence recognizing an important role for the state), nor do adherents of the NPE call for a return to the omniscient and benevolent state depicted by the structuralists.

Beyond acknowledging the importance of the private sector in development, however, neither school has sought to model and conceptualize the *political* role of private sector actors in development,[19] nor the interaction between these actors and

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[17] For a brief review of the astonishing success of the Taiwanese economy, see Wade (1990, pp. 34-51).

[18] For other views from the NPE literature, see for example Lee and Naya (1989), Alam (1989), or Datta-Chaudhuri (1990).

[19] There has been some excellent work done on conceptualizing the economic role of the private sector in development, but not its political role. A good example can by found in Paul (1990), in which the author

policymakers.[20] Straddling the neoclassical and NPE schools of thoughts, several authors have examined the business-government relations in East Asian countries. This literature, however, suffers from two major shortcomings. First, most of the discussion centers on governmental policy regarding the business sector, not on the independent role played by the latter. For instance, an important debate that has divided neoclassical and NPE scholars concerns the question of whether and to what extent government policy "led" or "followed" the market.[21] Although interesting, the debate sheds little light on the main concern of this study—understanding the political activities of private sector actors. Second, most of the literature on business-government relations in East Asia is concerned with Northeast Asia.[22] The application and extension of these findings to southeast Asia, and Indonesia in particular, is largely uncharted. One book ventured in this uncharted territory: *Business and Government in Industrialising Asia*, in which leading scholars from the neoclassical and NPE schools looked comparatively at the examples of North- and Southeast Asian industrialization to see whether and to what extent lessons learned in Northeast Asia were applicable to southeast Asian economies, and Indonesia in particular.[23] Although most of the contributions did touch upon the role of business in the political process, no integrated framework was offered.

Whereas both neoclassical and NPE scholars focus on the extent and nature of government intervention to determine whether the mix of policies is conducive to economic growth, the aim of this study is to focus on the interaction between market and nonmarket actors to make that determination. We rely on a different body of literature to do so.

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examines the role of the private sector in the economic development of Ghana and the policies that facilitate or hamper its contribution to economic growth.

[20] The interaction between private and public actors has focused, for the most part, on activities such as corruption or lobbying, on which a vast literature has been produced. The literature on corruption has focused on two types of issues—one addresses the factors contributing to the prevalence of corruption in a society (see for example Andvig and Moene, 1990), the other examines the effects of corruption on economic development (see for example Shleifer and Vishny, 1993). For an overview, see Clague (1997, pp. 13-36).

[21] See for example Amsden (1990) and Wade (1990) defending the view that the government "led" the market, while Balassa (1981) and Hughes (1988) suggested that the government "followed" the market.

[22] See for example Deyo (1987) and Haggard (1990) who focus on Northeast Asian political economy.

[23] MacIntyre (1994).

New Institutional Economics

In parallel to the work done by the neoclassical and NPE scholars, a whole body of economic literature has looked at the role of institutions in facilitating economic growth and development. This body of literature is commonly referred to as the New Institutional Economics (NIE). Fundamentally, institutions are socially devised constraints ("rules") on individual action.[24] With regard to the policymaking process in emerging markets, an institution is a body of rules or an organization which helps foster development, by pursuing its own particular agenda, with its own mission. The judiciary system, the military, religious organizations, trade unions, among others, are institutions which all have a mission statement which, to varying degree can support or hinder economic development.

As Douglass North emphasized in the lecture he delivered when he received the 1993 Nobel Prize in Economics: "Institutions form the incentive structure of a society, and the political and economic institutions, in consequence, are the underlying determinants of economic performance."[25] This study focuses on a particular kind of institutions—Commercial Power Centers—and on the role they play in policy formulation and implementation.

Two seminal papers by Ronald Coase have given the impetus to the entire NIE literature. Coase introduced the concept of transaction cost economics in his 1937 paper "The Nature of the Firm." In this paper, Coase argued that the firm exists as an institution to minimize certain transaction costs, such as work contracts between employers and employees, or between the firm and outside vendors. By centralizing contractual costs and obligations, a firm is able to reduce the transaction cost involved in every individual transaction. In his second seminal contribution, "The Problem of Social Cost" (1960), Coase solidified the crucial connection he had made earlier between institutions, transaction costs, and neoclassical theory. In this paper, Coase looked at the legal rules for the protection of property rights and suggested that the neoclassical result of efficient markets only exists in a world with no transac-

[24] Douglass North gives the definition of institutions as socially devised constraints on individual action (North, 1994, p. 360). Adam Smith referred to "laws and institutions," whereas James Buchanan simply refers to institutions as rules. Samuel Huntington sees institutions as processes by which organizations and procedures acquire value and stability (1968, see pp. 12-24). Rules codify these processes.

[25] North (1994, p. 359).

tion costs. Although costless transactions do not exist in the real world, strong competition can approximate such conditions, and efficient outcomes can be achieved without government intervention.[26]

The NIE literature is comprised of numerous subdisciplines.[27] This study relies and expands on three: (1) theory of economic regulation developed by the Chicago school of economics, (2) public choice theory and the emphasis on rent-seeking, as developed by the Virginia school of economics, and (3) collective action issues, as first conceptualized by Arthur Bentley and then challenged by Mancur Olson.

The next chapter examines and combines the insights of these three subfields of NIE to provide a conceptual framework describing the behavioral characteristics and modes of organization of market actors in their interaction with policymakers.[28] The chapter provides a formalized model of the role and influence of CPCs on economic policymaking. The model uses economic analysis to illustrate the workings of the political process involving the interaction between market and nonmarket actors. The analogy between economic and political markets seems to be the best way to depict the structure of incentives animating these actors. By understanding this structure of incentives, we can, as North argued, better understand the underlying determinants of economic performance.

DEFINING COMMERCIAL POWER CENTERS

We posit at this point and show through the analysis that commercial actors are an essential institution in the formulation, if not implementation, of economic policy in emerging markets. We call these actors commercial power centers, CPCs, which we define as:

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[26] The concepts used by Coase and their application to this study are examined in the next chapter.

[27] For a good summary of the NIE literature and its multiple strands, see Clague (1997, pp. 13-36) and Landa (1994, pp. 20-27).

[28] Initial efforts at developing such a framework of analysis were carried out at RAND in 1997. The methodology was exploratory and used four in-depth case studies to better understand the role and influence of commercial actors on economic policymaking in emerging markets. For reference, see the preliminary framework of analysis by Wolf (1997), and the case studies by Tong on China (1998), Robalino and Treverton (1998) on Mexico, Lesser and Zanini (1998) on Turkey, Levaux (1998) on Indonesia, and Treverton, Levaux, and Wolf (1998) for the overview document.

> Any group, combination, or coalition of large aggregate size, that seeks to influence the design and implementation of government economic policies to suit its diversified economic interests.[29]

This definition is very broad and requires discussion of the level of aggregation (*large aggregate size*, i.e., share of GDP) and of the nature of interests (*diversified economic interests*) of these groups. We start with the latter.

Three important points need to be made to describe CPCs' interests. First, CPCs operate on the demand side of a quasi-market for political influence on economic policy, in which the "goods" traded are taxes, subsidies, regulation, and other political instruments of economic policy. CPCs seek to protect or promote their economic interests by influencing this market. Second, although they pursue their economic interests, CPCs need not be economic in character. For instance, the military is a CPC in several emerging markets (e.g., in Turkey, see Lesser and Zanini, 1998), even though economic interests are not the military's primary interests. Third, CPCs are characterized by the diversity of interests they seek to advance or protect. As shown in the historical chapter and the case study, in the early stages of development of a market economy, CPCs seek to internalize market failures by expanding horizontally into conglomerates and, as such, have economic interests in diverse industries, with different policy priorities.

The reason for restricting our coverage of CPCs to groups with diverse interests is twofold. First, aiming at a macro-level picture of the quasi-market of political influence in economic policy, we restrict the analysis to the larger players.[30] Second, many of these groups internalize market failures and expand horizontally, in the form of sprawling conglomerates. As such, they seek to promote diverse interests .

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[29]This definition is similar to traditional definitions of pressure groups. See for example the following definition: "any group ... which articulates a demand that the authorities in the political system or subsystems should make an authoritative allocation [and which] do not themselves seek to occupy positions of authority" (Kimber and Richardson, 1974, p. 3, cited also in Austen-Smith, 1981, p. 143).

[30]For example, in his excellent analysis of the role of non-state actors in Indonesian policymaking, Andrew MacIntyre analyzes business associations with narrow interests in the textile (spinning), pharmaceutical, and insurance industries (MacIntyre, 1992). We do not include these associations in this analysis, as their interests are single-focused and the policies they seek to influence are very narrow in scope.

RESEARCH APPROACH

Overview

This study is divided in two complementary parts. The first part develops a new analytical framework to better describe and understand policymaking in emerging market economies, as well as to provide a better basis for action. The framework focuses mostly on the demand side of the market for economic regulation, in which CPCs are the largest and most influential actors. It relies on, and integrates several models of pressure groups and collective action. Some of these models are theoretical, while others are more applied. The second part consists of empirical results derived from historical analogies and from a case study in which the model is applied to the case of Indonesia.

The research approach is iterative inasmuch as the framework is influenced by the empirical work and, in turn, the empirical work follows the framework. The case of Indonesia serves thus as a template for applying the framework—whether to the case of Brazil, India, or other emerging markets.

Of direct relevance to the analyst trying to apply the framework, the dissertation answers the following two questions:

- What information about CPCs needs to be collected to build the framework?
- How should the information be organized to provide an accurate reading of the situation and a better basis for action?

Answers and insights about these issues are provided both at the theoretical and applied levels. The results of the analysis and the inferences that can be derived from it should be of interest to decisionmakers in government, international organizations, or business.

Propositions

Due to severe data limitations, it is impossible to formally test hypotheses related to the study of CPCs by relying on spotty aggregate macro- and micro-economic data for Indonesia. The approach of this dissertation is to be approximately right (providing a high level of confidence in assessing propositions), instead of exactly

wrong (testing models that are so constrained that they do not accurately reflect the real world, and relying on data of suspect quality). In lieu of formal hypothesis testing, this dissertation is guided by four propositions that help organize the thinking about CPCs.[31]

Proposition 1:

The development of CPCs is a normal phenomenon associated with the development of a market capitalist system; it is not aberrant, exceptional, or surprising.

Proposition 2:

The activities and policy influence of CPCs tend to grow as market capitalism develops. However, this growth may not be monotonic. As the number of CPCs increases, the result of their mutually countervailing effects may diminish their net influence.

Proposition 3:

The influence CPCs exert on policy can be (and sometimes has been) beneficial and healthy, and sometimes perverse and counterproductive.

Proposition 4:

In understanding policymaking and policy implementation in "emerging market economies," the role and influence of CPCs should be accorded prominent attention.

The assessment of these propositions is done both at the theoretical and applied levels. Propositions 1 and 2 are of positive nature. We rely on historical analogies and various models of influence and collective action to evaluate them on theoretical grounds, and the case study provides further evidence. Proposition 3 is normative. Our concern lies less in making a value-judgment about CPC activities than in underlining the variety of metrics (e.g., efficiency, equity, contribution to economic growth, or poverty alleviation) that could be used to evaluate them—and which would lead to different normative evaluations. Once an answer has been provided about the first three propositions, the fourth one is tautological—yes, if the first three propositions are correct, the role and influence of CPCs should be given prominent attention.

[31]These propositions are virtually *verbatim* from Wolf (1997).

Analytical Framework

This study relies on existing models of the influence of economic interest groups describing the behavior and incentives of participants in a quasi-market for influence on economic policy. Supply of economic policy is provided by the government and related institutions (e.g., regulatory agencies). Demand for economic policy comes from market participants (firms, industries, or conglomerates). The direct application of most existing models to emerging markets, however, is inadequate from the perspectives of both supply and demand.

In terms of supply of regulation, these models use the institutional background of mature economies with democratic institutions. This background is not directly applicable to most emerging markets, which are characterized by economies in the throes of economic development and, usually, with authoritarian governments.

On the demand side, traditional models use industry as the unit of analysis. The focus is on the activity of the firms. The underlying assumption is that firms within the same industry have common economic interests that, under certain circumstances, they will try to promote on a collective basis. This presupposes a fairly narrow set of collective interests centered on an industry's activities.

In contrast, in emerging market economies, market and nonmarket (government) mechanisms and institutions are still in formation and suffer from multiple failures. As a result, companies have broad interests, and they try to internalize and address many of the shortfalls of markets and governments—typically, by expanding horizontally to form large conglomerates. Therefore, given these diversified interests that sprawl across a large spectrum of activities, conglomerates have a desire to "see the system work." As such, their shared interests are broader than the narrower economic interests of firms belonging to a given industry.

Because they often straddle several markets, the common characteristics and interests of these groups stem less from their common industrial or service activities and more from common ownership structure and/or sources of revenues. Although, in practice, there is often some degree of commonality between ownership and/or sources of revenues, and activity (i.e., firms with similar owners or sources of revenues are often in the same business), the relevant common characteristics pos-

sessed by members of a CPC have in common is their ownership and/or sources of revenues. Thus, the level of aggregation used in this study to analyze CPCs is novel.

Historical Analogies

The concepts just described are highlighted through an historical excursion to medieval and mercantile Europe. The reliance on historical examples is motivated by a desire to better understand the functioning of the quasi-market for influence.

Although the historical gap between today and these time periods may seem too large for meaningful comparison, such is not the case for three reasons. First, because capitalist markets *emerged* from these two periods, it is useful to observe the evolution of the quasi-market of political influence in its embryonic and infancy stages.

Second, in many respects, the longer historical perspective is more appropriate to the case of today's market economies. The twin process of deregulation and internationalization undergone by these markets represents institutional challenges not encountered in the recent history of the West's mature economies. Medieval and mercantile economies, in contrast, did transform from traditional to market economies, while undergoing a political process of state building. This process involved increased trading among towns and regions of one country, as well as growing international trade.

Third, most readers are quite familiar with the economic history of nineteenth and early twentieth century entrepreneurs. Despite some obvious similarities with entrepreneurs in today's emerging markets, the institutional setting is quite different and historical analogies based on that period could be misleading.[32] Indeed, *constitutional liberalism* in emerging markets is still in its infancy.[33] The rule of law, private property rights, separation of power, and freedom of speech and assembly are all aspects of constitutional liberalism that existed and were well developed in nineteenth century United States. Today's emerging markets are in the process of devel-

[32] This point was made, for example, by Leff: "Private entrepreneurs in the contemporary LDC's [less developed countries] possess little of the social and ideological legitimacy that protected robber barons in the United States" (Leff, 1979, p. 56).

[33] On the discussion about constitutional liberalism and democracy, see Fareed Zakaria's article in *Foreign Affairs* (1997).

oping these institutional arrangements, just as medieval and mercantile Europe did over the course of several centuries.

In *The Wealth of Nations*, Adam Smith reviles mercantilism, just as he reviles its "sole engine," monopoly.[34] The book is replete with condemnations of monopoly and monopolists. To build his case against the mercantile system, Smith relies greatly on the example of woolen manufacturers.[35] Their influence on the government was unrivaled, according to Smith. By analogy, it seems that the "sole engine" of Indonesian economic success is based on the granting of monopoly rights and what Smith refers to as monopolists (pressure groups or CPCs in our framework) who play an active role in Indonesia's policymaking. The case study examines the role of CPCs in Indonesia.

Case Study

There are one necessary and three sufficient reasons for using Indonesia as an example of the CPC analytical framework. The three sufficient reasons are the following:

- The Indonesian economy's rapid economic growth in the period of 1970-1997 provides a good example of emerging markets
- Cronyism, collusion, and nepotism have been conspicuous in Indonesia
- The 1997-1998 crisis and Indonesia's relations with the IMF provides an opportunity for testing the value of the method.[36]

We do not address directly these three sufficient reasons, for they are discussed throughout the case. The necessary reason is that the overwhelming majority of Indonesia's observers pay scant attention to the role of non-state actors in the country's decisionmaking. Indeed, the one common point among virtually all

[34]"Monopoly of one kind or another, indeed, seems to be the sole engine of the mercantile system" (Smith, Book IV, Chap. VII, p. 146).

[35]"Our woolen manufacturers have been more successful than any other class of workmen, in persuading the legislature that the prosperity of the nation depended upon the success and extension of their particular business" (Smith, Book IV, Chap. VIII, p. 165). Smith used many other examples of special interest protection, but he kept his harshest words for the woolen manufacturers.

[36] Treverton, Levaux, and Wolf (1997) checked the relevance of the approach, based on the first Memorandum of Understanding (MoU) between the government of Indonesia and the IMF. They concluded that, given the incentives of major CPCs, the MoU had virtually no chance of being implemented.

academic views about decision-making in Indonesia is the central role attributed to the state and the relative or total neglect of non-state actors as parties of, or even inputs to, the decisionmaking process.[37] Moreover, this neglect is a pervasive characteristic of most analysis of emerging market policymaking. This consensus has permeated the media and the policy establishment in western countries as well.

The generally accepted view of Indonesian policymaking is a mixture of the works of Riggs (1964) in the early 1960s and of Harold Crouch (1979) in the late 1970s. Riggs sees the bureaucracy as ruling the state without due concern for society's interests. The bureaucratic elite and the political elite have patrimonial relations relying on the sharing of the spoils of office to remain in power.[38] All other groups are effectively excluded from political participation, especially the Sino-Indonesian business community that has no political representation whatsoever. (Hence, Riggs' use of the term *pariah entrepreneurs.*) Crouch describes Indonesia as a patrimonial state as well, characterized by intra-elite rivalry over the distribution of public largess, rather than competition over substantive policy issues. He stressed the resemblance of Suharto's rule to that of a traditional Javanese king. Crouch did, however, qualify this and correctly conjectured that economic development was likely to bring forth issues of substantive relevance. He later acknowledged the growing importance of a capitalist class in Indonesia and the potential political role that it could play, although he remained skeptical about its political impact.

Although quite dated, these views of the role of the state in Indonesian politics have shaped subsequent prisms. Crouch's parallel between Suharto and a Javanese king has been particularly widely accepted. Yet most of the academic writing on Indonesia refers to Indonesia before the deregulation drive which started in the mid-1980s, and little substantive analysis has been published about the nature of the relationship and division of task between state and nonstate actors in policymaking since then.

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[37]Andrew MacIntyre (1992, 1994) is the main author stressing the role of non-state actors in Indonesian policymaking. William Liddle (1985, 1987) makes the same case, although less forcefully. For a succinct review of the different views about Indonesian political decisionmaking see MacIntyre (1992, pp. 1-21). As a general proposition, several authors have stressed the growing importance of non-state actors in the modern capitalist system, such as Peter Drucker and Kenichi Ohmae.

[38]For a discussion about the concrete differences between patrimonialism and bureaucratic control, and their relevance to understanding Suharto's regime, see King (1979). King concludes by presenting-a variant of Riggs and Crouch models, suggesting that Indonesia is best characterized as a bureaucratic-authoritarian regime, in which, like in other models, non-state actors play no significant political role.

The more recent monograph by MacIntyre (1992) mentioned above does recognize a significant role for business and business associations in the policymaking process. MacIntyre's work, however, is based on three case studies highlighting the increased importance of nonstate actors in Indonesia's policymaking process, but it does not provide an overarching analytical framework. This study provides such a framework.

ORIGINALITY AND POLICY RELEVANCE

Three aspects of this study stand out as particularly original and policy relevant. First, the focus of the study is novel. It addresses the *political* role of market actors in economic policymaking in emerging markets and their relationship with nonmarket actors. As the brief survey of the literature revealed, virtually no work has been done on this topic with application to emerging markets. The few monographs that have addressed the issues have been country-specific and have failed to offer an integrated framework of analysis. For the most part, the literature on East Asian development (neoclassical vs. NPE) has addressed issues about the role of the private sector in development that are related to, but not directly focused on, its political role. By failing to address directly the political role of market actors, scholars from both sides of the debate end up trading arguments that appear to be based more on ideology and personal conviction than facts. By presenting a model of positive economics describing the quasi-market for political influence, we avoid much of the discussion about normative assessments of the respective roles of governments and markets—although the model allows for such normative extrapolations.

Second, to address the issue at hand, the study reviews and combines insights from various disciplines and schools of thought to propose an integrated analytical framework that is applicable to emerging markets. It combines economic, historical, and case study analysis to address an inherently multi-faceted problem. Some of the models used here have been developed a few decades ago for describing mature democratic economies and have not been applied to developing economies. To make analogies relevant to today's emerging markets, the historical analysis goes back to the early development of capitalism, instead of using examples from western economies in the late 19th and early 20th century—which we show not to be valid because of the disparity in institutional development.

Third, with respect to Indonesia, our contention is that the old prisms and frames of reference have been overtaken by events (economic liberalization), and a new approach to understanding Indonesia's economic decisionmaking is required. The CPC analysis goes some distance toward such an understanding and toward providing a much needed analytical framework for placing nonstate actors in Indonesia's policymaking process.

Just as it was difficult for most observers, whether in academia or policymaking, to recognize inherent weaknesses in the Soviet system, it has been difficult for Indonesia's observers to recognize that the structure of the country's economy has profoundly changed over the past decade of economic liberalization. The balance in relations between state and economic actors has shifted dramatically in favor of the latter. The role of business groups in policymaking has surfaced only with the current crisis and is limited to a close examination of the business empires of the first family.

The CPC-based framework provides a more systematic approach to the study of business interests in Indonesia and their influence on economic policymaking. It suggests that the current system, with the concentration of power working to the benefit of the presidency, cannot survive given the powerful pressures exerted by nonstate actors on policymaking. Diversified economic interests require a diversified set of institutions to transmit and transform the needs and demands of nonstate—mostly business—actors in the political process.

More broadly, the CPC framework can be used by national and international aid and lending institutions, the intelligence community, and multinationals. These three constituencies need to assess the political stability and the sustainability of economic development of various emerging market economies. Neither assessment can be done adequately without evaluating the role of private sector actors in the policymaking process.

The post hoc admissions by both the World Bank and the IMF that they had erred at the beginning of the Asian financial crisis due to a poor assessment of "local conditions" highlights the need for these institutions to have a good understanding of local policymaking *before* the onset of crises. The framework can also be used by the intelligence community to organize its data collection activities in emerging markets.

Indeed, neither the political stability nor the sustainability of economic development can be evaluated adequately without including the role of private sector actors in the policymaking process of emerging markets. Finally, the framework can be used by private multinationals to guide their investment and long-term business strategy in emerging markets. Choosing the "right" business partner is a crucially important decision that is best made with reference to the relative position of CPCs in the economic and political life of the host country. We develop these themes throughout the study and in the last chapter on the policy implications of the analysis.

OUTLINE

The dissertation is comprised of six chapters, including this one. The next chapter provides a survey of the literature on collective action, regulation, and rent seeking to characterize the quasi-market for political influence on economic policy. The chapter first describes the quasi-market, the 'goods' traded in it and its participants. It then describes key behavioral characteristics of the participants in the quasi-market. Finally, it presents the model of choice, developed by Gary Becker in two articles on pressure groups (1983, 1985). The chapter concludes with a discussion of propositions 2 and 3. Indeed, the activities and influence of CPCs expand, although not monotonically, as market capitalism develops. Depending on the level of competition in the quasi-market, the influence CPCs exert on policymaking can be beneficial and healthy, and sometimes perverse and counterproductive.

Chapter 3 presents historical analogies from the medieval commercial revolution (11th-14th century) to the early mercantile era (15-17th century). The historical excursion provides insight and develops intuition about the market for political influence on economic policy, which seems relevant to today's emerging market economies. This historical overview vindicates Propositions 1-3. First, the development of CPCs is typical, normal, and not surprising. It is a normal phenomenon associated with the development of a market capitalist system. Second, the activities and policy influence of CPCs tend to grow, although not monotonically, as market capitalism develops. Third, the influence that CPCs exert on policy can be beneficial or perverse, depending on the metrics used for the normative evaluation and on the environment in which the activities of CPCs take place.

Chapter 4 applies the framework of analysis to Indonesia. It starts by describing the methodology used to identify, describe, and assess CPCs' activities and influence. Then, the framework is applied to Indonesia and presents a description of Indonesian CPCs, of their effectiveness, and of the channels of influence they use to accede to the relevant policymakers.

Chapter 5 assesses the interaction between CPCs and policymaking. It presents four key policy issues confronting Indonesia today—namely, banking supervision, SOE reform, trade liberalization, and investment deregulation. Each policy discussion concludes with an evaluation of the position of each CPC regarding the given policy and which channels of influence are used to affect the policy outcome. The chapter finishes with an overall articulation of CPCs' inferred interests in the four policies. This chapter validates proposition 4. The chapter highlights the importance of understanding the position and influence of CPCs when dealing with policy issues of interest.

After the case study, policy implications are offered. They highlight the non-orthodox inferences that can be made about the future by wearing the CPC spectacles, as opposed to other types of monocles. We conclude with a discussion of avenues for further research by underlining key issues that could not be addressed within this framework but are worthy of attention.

CPCS IN EMERGING MARKETS: WHY? WHAT? AND HOW TO INFLUENCE POLICYMAKING?

As mentioned in the outline, this chapter offers a formalized model to depict the role and influence of CPCs on economic policymaking. To present the model, we first describe the characteristics of the quasi-market for political influence on economic policy, before describing the behavioral characteristics of the participants in the quasi-market.

The framework of analysis is basically a supply and demand model, in which the goods traded are instruments of political influence on economic policy like taxes, subsidies, regulations, and the like. The suppliers of these goods are *nonmarket actors* (state actors writ large—i.e., all branches of government and regulatory agencies). The consumers of these goods are *market actors* (i.e., actors in commercial markets who are affected by the goods—ranging from industries to individual firms, including pressure groups and, in the extreme, individual consumers).[1]

Despite the analogy with private markets, the market for political influence is fundamentally different in one very important respect. Prices in a political market, which are the key ingredient of markets, are not publicly known nor clearly set. There is no clearly identified price to avoid paying taxes, or to obtain a subsidy, or to have a costly regulation abrogated. Therefore, and to avoid confusion with other markets, we refer to this market as a *quasi-market.*

Prior to describing the equilibrium mechanisms of the quasi-market, we first need to address three key behavioral characteristics of its main actors on the demand side—CPCs. We present these characteristics by answering three questions:

[1]On the definition and discussion of market and nonmarket concepts, see Wolf (1993).

- Why do CPC members seek to influence policy? Why as a group?
- What policies do they seek to influence?
- How do they influence policy? Through which channels do they accede to policymakers?

WHY INFLUENCE?

The first question this section addresses is: Why do market actors (e.g., firms, CPCs) seek to influence economic policy? Why do they seek to influence nonmarket actors (e.g., government employees, politicians) in charge of economic policy? To answer the question, the analysis relies on the existing literature of rent-seeking , developed mainly by the so-called Virginia School of economists (since many of the pioneers of the rent-seeking literature were from the Virginia Polytechnic Institute or Virginia State University).[2]

In this rent-seeking framework, CPCs seek to influence economic policy so as to derive rent, which we broadly define as:

> A stream of revenue stemming from preferential economic policies or regulations that promote or protect CPCs' interests.

Under a rent-seeking perspective, CPCs seek to obtain rents, which can accrue from private markets—departing from archetypal perfect competition, or from government intervention—seeking to address the market failures. Thus, CPCs want to influence policymakers because they have a vested, self-regarded interest to do so.[3]

The standard economic definition of a rent (stemming from Ricardo's writings about pure land rents) is a payment in excess of the opportunity cost of a resource.

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[2]Two compendia of articles on rent-seeking include most of the relevant literature: *Toward a Theory of the Rent-Seeking Society* (Buchanan, Tollison, and Tullock, 1980), and *The Political Economy of Rent-Seeking* (Rowley, Tollison, and Tullock, 1988). James Buchanan, Gordon Tullock, and Robert Tollison are among the prominent members of the Virginia School. The 1980 compendium includes the three classic articles on rent-seeking: "The Welfare Costs of Tariffs, Monopolies and Theft" (Tullock, 1967), "The Political Economy of the Rent-Seeking Society" (Krueger, who coined the term *rent-seeking*, 1974), and "The Social Cost of Monopoly and Regulation" (Posner, 1975).

[3] This study focuses on the rent-seeking activities of market actors, and not on the rent-seeking of nonmarket actors—trying to exchange, on a *quid pro quo* basis, political influence for financial compensation. The amount of rent they derive in the trading of political influence is trivial compared with that derived by market actors. According to a study by Ozay Mehmet, in 1990-91, the amount of money derived by top-level bureaucrats from corruption was $315 million—representing one quarter of one percent of GDP. Although crude and conservative, these estimates reveal the trivial amount (in financial terms) of "gate-keeping" corruption by Indonesian bureaucrats. (Mehmet, 1993).

Economic rent is a payment in excess of the amount a resource would command in its best alternative use. In the archetypal situation of perfectly competitive markets, there are by definition no rents available because, on aggregate, all firms produce at the efficient level, where price equals marginal cost. The best alternative is a loss, which proves not to be a good incentive to continue participating in the market. In fact, some firms manage to generate profits, some run losses and, overall, the market does not generate either profits or losses in the idealized, perfectly competitive market regime.

The key to the efficient outcome in production (i.e., minimizing the input to output ratio for specified output levels) is the mobility of resources, factors of production, prices, and information, which all permit markets to efficiently allocate resources to the most productive uses.[4] The reality of markets is different, and they all suffer some shortcomings. Broadly, there are four sources or types of market shortcomings: externalities and public goods, increasing returns, market imperfections, and distributional equity.[5] Such market inadequacies abound in economies in transition, like those of emerging markets.

Negative externalities create a wedge between social and private costs, which is not borne by the generator of the externality. For example, a firm polluting a river is imposing costs to society (e.g., dead fish, contaminated water) which it does not bear. As a profit-maximizer, the firm will fight environmental regulations that would impose extra costs to the firm (e.g., filter the water before dumping it). The firm will often seek government regulation that would allow it not to have to bear the full cost of pollution or that will level the playing field among all firms of the industry. Another problem occurs when, to reap the benefits of increasing returns to scale in industries such as steel manufacturing or aerospace, governments—whether on their own or influenced by market actors—divert investment to these industries and

[4]Prices and information are closely related. Friedrich Hayek and other economists of the Austrian school considered price mechanisms as a "procedure" to generate information (see Wolf, 1993, p. 6).

[5]Most economists do not consider distributional equity a market failure and limit these to allocative mechanisms that do not produce efficient outcomes (i.e., the outcomes of a perfectly competitive market). We do consider distributional equity as a type of market failure, but we don't address the issue directly in this analysis because our focus is mainly directed at the influence of market actors on nonmarket actors. In most cases, market actors do not actively seek to improve distributional equity through political influence. We discuss distributional equity in the *what to influence* section. For a clear and concise discussion of market failures, including distributional equity as a market failure (see Wolf, 1993, pp. 35-58 passim).

protect them through protective tariffs and the like.[6] With market economies still in their infancy, emerging markets are rife with these and other market imperfections. Inadequate information flows contribute to poor price signal mechanisms, which leads to the misallocation of resources.

Although the economics literature is replete with studies evaluating the size, frequency, and impact of market failures, this is not the purpose of this section. For our purpose, the most important aspect of a market failure is that "where there's a failure, there's a potential rent."[7] In the presence of a market failure (e.g., if information among market participants does not flow well), the producer is able to charge a price above the price of perfect competition and to supply less of the good, hence generating extra profit. Any market failure means that a clever entrepreneur can discover a way to invest resources in that market and generate profits up and above the best alternative of a perfectly competitive market. This quest for rent is referred to as rent-seeking, which we divide in two categories: profit- and rent-seeking.

Profit-seeking stems from the private activity of entrepreneurs, without government intervention. Rent-seeking, in contrast, is the activity of rent-seekers who seek government protection or help in capturing rents. Rent-seeking thus can be defined as:

> The political activity of individuals and groups who devote scarce resources to the pursuit of rent rights granted by governments.

As we have seen, in a static situation of perfectly competitive market equilibrium, no rents are available. However, in a dynamic perspective, rents are available in the short term to the innovative entrepreneurs who find ways to produce in a more efficient manner. If an entrepreneur finds a more efficient technique or organization of the production process for a given good, initially, the production costs using the innovative process are lower than the competitors' and the entrepreneur is able to

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[6]This argument is not new. It was originally developed by Friedrich Lizst, the German economist, who espoused a policy of protective tariffs to achieve German industrialization (which, according to Lizst, was lagging behind Great Britain and others in its industrialization). Earlier, Alexander Hamilton in his 1791 *Report on Manufactures* argued in favor of protective tariffs to protect American manufacturers from British competition (see Gillis et al., 1983, pp. 440-458 passim).

[7] This is true in the case of most market failures, but not in the case of public goods such as national security. In this latter case, rent is not necessarily associated with the market failure.

extract an extra profit—since production costs are lower than the going market price. In this scenario, entrepreneurs are always looking for alternative uses of their resources to obtain additional profit.[8] As long as this quest for rents does not involve political activities (i.e., government assistance), we define the activity as profit-seeking.

During the initial period, the entrepreneur is effectively a monopolist. It is the prospect of the extra monopoly profit that motivates his entrepreneurial activity. Other entrepreneurs, however, are attracted by the profits available from applying the new production process. They start to imitate, if not improve upon, the innovative production technique. Over time, the entire industry adopts the new technique, and there is no more extra profit to be gained. The original rent is said to have been fully dissipated in the process of competition. The more competitive the market and the lesser the restrictions on entry into the market, the faster the rent will be fully dissipated. Over time, rents will disappear as new entrants, attracted by the profits, find ways to enter the market. Profit-seeking therefore contributes to the creation of added value, in the context of dynamic and ever-changing private markets.

From a social welfare standpoint and in a dynamic perspective, profit-seeking activities are positive because, at the end of the process just described, the price is lower than at the beginning (for a given level of quality), and social welfare is increased since consumers get more for the same price, and producers produce more. For both, the market "pie" grows bigger from entrepreneurial activities. From an efficiency standpoint and, again, in a dynamic perspective, the profit-seeking activity of entrepreneurs leads to a more productive economy that better allocates resources (i.e., it takes relatively less inputs to produce each unit of output). From this standpoint, the profit-seeking interest of entrepreneurs is positive since new investments and energies are channeled to new and more efficient techniques of production.[9] In the process, some producers fail and exit the market, while new entrepreneurs enter the market. Similarly, inefficient production techniques are replaced by newer, more efficient ones. The process, referred to as *creative destruction* by Joseph Schumpeter

[8] This dynamic perspective of innovative entrepreneurs seeking new ways to produce more efficiently was first developed by Joseph Schumpeter (1947) with his concept of "creative destruction."

[9] We refer to techniques of production very broadly. We include all forms of organization of production, new technologies, process, etc. that improve on existing processes and methods.

is the very essence of capitalism and is considered as the fundamental cause of the success of capitalism.

In short, profit-seeking has three key characteristics. First, creative destruction (which is motivated by profit-seeking) is, in the words of Schumpeter, "the fundamental impulse that sets and keeps the capitalist engine in motion."[10] The profit-seeking process is positive because it generates positive social returns over time. Second, the process takes place in private markets, free of any government intervention. Markets efficiently allocate scarce resources to the best possible uses. Third, overall, the competitive dynamics of private markets lead to the full dissipation of rents. We therefore make a clear distinction between profit-seeking (which creates positive social returns) and rent-seeking (which does not).

Adam Smith argued that the "sole engine" of mercantilism was monopolies (see discussion in the next chapter). In our framework, we call this engine rent-seeking.[11] Profit-seeking becomes rent-seeking when we change the institutional setting from private to political markets. Profit-seeking turns into rent-seeking when the entrepreneur seeks some type of preferential government regulation to generate or protect a rent. To generate a rent, the nonmarket actor sets conditions for the rent to arise (e.g., by handing out a subsidy). To protect a rent, the nonmarket actor adopts regulatory legislation or a preferential tax structure to the benefit of existing beneficiaries of rents (e.g., restrictions on entry into industry).

There are countless examples of how market actors generate or protect rents.[12] Among others, restrictions on entry into a particular industry are a widely used technique. An example of targeted rent generation is entry restriction advocated by proponents of the nurturing of infant industries (to capture profits generated from increasing returns to scale, through protective tariffs and funded by government funds). Examples of rent protection are barriers to entry set up after control of an

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[10] Schumpeter (1947, p. 83).

[11] For a review of the rent-seeking model, the reader is referred to the articles included in the two compendia on rent-seeking mentioned earlier. Probably the best summaries of the model can be found in Buchanan (1980, pp. 3-15 passim), and in Ekelund and Tollison (1981, pp. 17-28 passim). An excellent overview is also provided by Mitchell and Munger (1991, pp. 523-531 passim).

[12] For an review of various types of rents, see Conlon and Pecorino (1998), who develop an interesting model comparing rent seeking and lobbying (which takes place, in their model, when people are driven out of rent seeking by reform and seek to obtain a new rent).

industry by one or a few firms. Once a limited number of firms or a conglomerates are formed and reach sufficient scale, they seek government protection of the businesses they control.

In other cases, entrepreneurs obtain regulations that fix the price of the good (e.g., in the utility industry or for staple food commodities). Entrepreneurs can also lobby the government to obtain import licenses or seek relief from tax payments, etc. Regardless of the form of the rent, once one entrepreneur receives special protection from the government, it serves as a signal to other entrepreneurs to also seek government-protected or government-promoted rents. Before long, a whole class of entrepreneurs looking for potential rents emerges and lobbies government officials to be awarded rent rights. Profit-seeking is replaced with rent-seeking, and a quasi-market for political influence is born.

Because of the power of the state in enforcing laws and regulations, rents promoted or protected by the state are the most valuable to rent-seekers. As we shall see in the historical section, merchants joined guilds to extort economic rents and other privileges from local rulers as early as in the high Middle Ages. Because rents constitute streams of future income, the durability and permanence of the government guarantee critically affects the valuation of the rent. Hence, beyond the pecuniary benefit of a rent that an entrepreneur can extort from a nonmarket actor, the entrepreneur has a vested interest in the overall development of a nonmarket sector that can adequately grant and protect rents. The logic of this interest by market actors in the "overall" development of the nonmarket leads, provocatively, to the adoption of policies that may raise efficiency—i.e., in time, policies that undermine the system of rents. We develop these issues pertaining to the development of nonmarkets in the section on *what to influence.*

Entrepreneurs seek rents through the state for one additional reason. In many instances, several of them are in the same business environment, and hence face the same market failures. It may sometimes be in their interest to cooperate in addressing a market failure. Often, such cooperation results in cartel-like agreements.[13] For example, palm oil producers may seek to cooperate to set a minimum price to avoid

[13]For conditions that predispose markets to seek cartelization, see Posner (1977, pp. 213-215).

cut-throat competition that could eliminate some of them. If the cartel is set up privately, without government support, it is likely to unravel quickly. Sooner or later, there will be one producer who will break the agreement and lower its prices to obtain a large order. If, however, the minimum price is set and enforced by the state, then entrepreneurs can be reasonably certain that the cartel agreement will be upheld.

Both in the case of profit- and rent-seeking behaviors, individual entrepreneurs pursue their own self-interest. In both cases, the entrepreneur seeks potential rent and tries to slow down the dissipation of the rent. Yet, the two processes lead to opposite outcomes. Contrary to the traditional economic rent of private markets, the rents of the quasi-market are generated from the diversion of resources that could otherwise be put to more efficient use. In private markets, profit-seeking induces entrepreneurs to imitate or improve on an existing production technique—thereby contributing to an efficient allocation of scarce resources. In contrast, in the quasi-market for political influence, rent-seeking induces entrepreneurs to compete for rents secured by nonmarket actors. This requires resources and activities dedicated to influencing nonmarket actors. Such influence-seeking activities are inherently non-productive and waste scarce resources.[14]

To sum up, market actors (whom we have metaphorically referred to throughout this section as entrepreneurs) seek to address market failures to derive rent. They can do so within private markets by improving production techniques or by devising organizational structures that can cope with market failures (e.g., establishing horizontal conglomerates to deal with poor price mechanisms). Addressing market failures without recourse to government protection, which we call profit-seeking, is inherently positive and enhances social wealth and welfare. Table 2.1 compares profit- with rent-seeking, as suggested by the traditional public choice school (e.g., Virginia school).

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[14]According to Becker, however, rent-seeking activities can increase overall efficiency if the quasi-market is competitive and open to entry (see below).

Table 2.1

Profit- vs. Rent-Seeking

	Profit-Seeking	Rent-Seeking (Virginia school of public choice)
Type of activity	Private, economic activities	Public, political activities
Goal of activity	Generate profit out of situation of temporary market monopoly	Generate rent through granting of preferential policy by government
Impact on economic efficiency	Static view: negative (monopoly) Dynamic view: positive (more efficient allocation of resources)	Negative: rent-seeking always constitutes a diversion of scarce resources
Intellectual forebears	Schumpeter (creative destruction)	Adam Smith (monopoly) and Virginia school (Buchanan, Tullock, etc.)

To be granted rents or to protect rents they have already captured, market actors can also seek to influence nonmarket actors. The motivation for such a behavior is both economic and political. Rents granted and protected by the state are attractive from an economic standpoint because they provide a stream of revenue up and above the competitive price and hence generate extra profit. This motivation is identical to profit-seeking. From a political standpoint, they are attractive because the owner of the rent benefits from the protection of the state in recognizing the market actor's property right over the rent. This protection, however, is credible only so long as the power of the state is credible as well. Therefore, market actors have a vested interest in seeing the development of a nonmarket sector that can adequately grant and protect rents.

The rent-seeking behaviors described above explain the activities of individual market actors. However, in reality, individual market actors are unlikely to act alone for two complementary reasons. First, the bargaining power of the individual is rather limited against nonmarket actors. Collective action by several market actors seeking to share the rent is more likely to succeed as a method for extorting rent. Second, by seeking rents through collective action, a group of market actors can create a cartel and effectively limit, if not eliminate, competition for the rent. Involving the state in the granting of such rents strengthens the cartel and is more likely to lead to its success.

WHY INFLUENCE AS A GROUP?

Introduction

The foregoing discussion has described the motivation of individual market actors in trying to influence policymakers to derive economic rents. These rents are traded and fought over in the quasi-market for political influence on economic policy. It is the prospect of obtaining these rents that motivates the activities of market actors. The motivation is congruent with our definition of CPCs which, to recall, describes a CPC as:

> Any group, combination, or coalition of large aggregate size, that seeks to influence the design and implementation of government economic policies to suit its diversified economic interests.

The object of this section is to seek to understand what motivates CPCs to act collectively and which conditions are conducive to collective action. Once these conditions and motivations are better understood, we can define with more accuracy what type of groups CPCs are and what their key characteristics are in terms of size, membership, and level of aggregation. The combined findings of this and the previous section allow us to characterize the demand side of the quasi-market for political influence on economic policy. The next section will characterize the supply side of the quasi-market.

To organize CPCs into the consumers of the quasi-market for political influence, two assumptions need to be made. The object of this section is to validate them. First because, at least in emerging markets, in most cases CPCs are not public organizations, with headquarters listed in the phone book, we have to infer the composition of CPCs from common interests among sub-segments of market actors. To make this inference, we need to assume that common economic activities and sometimes other (e.g., ethnic) characteristics lead to the formation of CPCs. Second, because CPCs do not publish policy documents explaining their policy objectives, we need to infer their objectives based on the shared interests of the members of each CPC. To make this inference, we need to assume that common interests lead firms to join forces into a CPC to influence policy-making/makers. Taken together, the two assumptions allow us to make the crucial semantic leap of the CPC-based analysis: to infer CPCs' interests based on the objective interests of their supposed members.

The aggregation of individual firms into a CPC is therefore a critical task. In some instances, the task is facilitated by the ease with which some sub-segments of market actors can be identified. For example, it is much easier to set the boundaries surrounding foreign firms in the oil and gas business in Indonesia, than it is to set the boundaries of the Sino-Indonesian CPC. Which firms or conglomerates owned by Sino-Indonesians belong to the "Sino-Indonesian" CPC? Which would be the criteria for including or excluding some firms from this CPC? We discuss these practical issues in the case study.

The section evaluates the two key assumptions described above by looking at three key questions related to the analysis of groups: group formation, group cohesion, and group objectives. Although these three issues are analytically distinct, for simplicity of exposition, we address the three questions jointly when presenting the various models of collective action.

The first questions that arise when thinking about group activities are: how and why do groups form, how do they maintain their cohesion, and what common objectives to they pursue? Despite the apparent legitimacy of these questions, they are not often raised. As James Q. Wilson correctly remarked: "Theories about how organizations behave abound; theories about how organizations come into being scarcely exist."[15] The reason for this shortcoming stems in large part from the tremendous complexity and diversity of groups and organizations.

We limit ourselves here to groups of economic character in order to reduce the complexity and diversity of the issues at stake. There are essentially two paradigms explaining group formation, cohesion, and objectives; and like any paradigm, they have generated a vast amount of commentaries, critiques, and the like. We present these two paradigms, which will be blended in our proposed model.

Bentley's Group Theory of Government

The first paradigm centers around a "group theory" of government first proposed in 1908 by Arthur Bentley. The theory became known as the pluralist theory of interest

[15] Wilson (1974, p. 195).

groups.[16] For Bentley, government policy and actual political choices are the result of, and are fully determined by group pressure. Bentley defines group interests in terms of their conflict with one another and excludes the notion of government acting for the common good. "Pressure ... indicates the push and resistance between groups. The balance of the group pressures *is* the existing state of society."[17] This view is unique in the subsequent treatment by economists of political behavior, which all assume that actual political choices are determined by the efforts of voters, politicians, bureaucrats, and political parties.[18]

Bentley sees group formation, cohesion, and objectives as one and the same. For him, "there is no group without its interests," and "an interest ... is the equivalent of a group."[19] Similarly, group and group activities are synonymous. In this view, there is a complete identity of interests between individual aspirations and group formation, as well as between individual and group goals. Table 2.2 summarizes Bentley's key propositions.

Table 2.2

Key Group Attributes in Bentley's Model

	Bentley's Model
Group formation	Easy (out of shared interests)
Group cohesion	Easy to maintain (out of shared interests)
Group objectives	Identity between individual and group objectives
Group's political effectiveness as a function of its size	Increases
Equilibrium in quasi-market for political influence?	Yes

If this theory is correct, then our two key assumptions are verified: CPCs are formed out of the shared interests of their members, and it is fully appropriate to derive

16 It is worth noting that, although considering himself as an economist (and viewed as such by Gary Becker), the following of Bentley lies mostly among political scientists. For a more recent treatment of group theory, see also Commons (1950) and Latham (1965). For a critique of the pluralist theory, see among others Connolly (1969) and Olson's criticism of orthodox theories of pressure groups in Olson (1965, Chapter 5, pp. 111-131 passim).

17 Bentley (1908, pp. 258-259, emphasis in the original).

18 See for example the works of Schumpeter (1947), Downs (1957), Buchanan and Tullock (1962), and Niskanen (1971). Gary Becker is the first "modern" economist to share Bentley's view about the centrality of pressure groups in the political process (see below).

19 Bentley (1908, p. 211).

CPCs' goals and interests from those of their members. In the same way, because of the existence of shared interest, it is appropriate to aggregate firms and conglomerates into CPCs. In terms of quasi-market for influence, Bentley sees interest groups as the only actors of interest. Nonmarket actors only transmit and transform the conflicting pressures of interest groups. But is this theory correct? Two pieces of evidence contradict the theory.

In essence, the pluralist paradigm claims that common interests, however defined, automatically lead to the formation of groups organized around the promotion and protection of those shared interests. However, if such was the case, then one would expect to see relatively more groups organized around interests shared by a greater number of people. The empirical evidence does not support this view. Using census data and listings of interest groups, it has been shown that there is little correlation between the number of people sharing common interests and the formation of groups around the promotion of these interests.[20] For instance, although only 7 percent of the population is occupied in managerial or administrative positions, 71 percent of organizations are organized around the promotion and protection of their interests. This analysis is congruent with the ground-breaking work by Schattschneider, who noted that "the business community is, by a wide margin, the most highly organized segment of society."[21]

The second piece of evidence advanced against the pluralist theory is that "the formation of associations tends to occur in waves."[22] Indeed, both in Western Europe and the United States, there have been periods of great activity in group formation, followed by periods of slow group formation. According to later writers, there is no reason, however, for interests to come in waves.[23] The most conspicuous

[20] Schlozman and Tierney, (1986, pp. 69-71);.see also Shepsle and Bonchek (1997, pp. 224-225).

[21] Schattschneider (1960, p. 30).

[22] Truman (1971, p. 59).

[23] See for example, Wilson (1974, pp. 198-201 passim). In our framework of a quasi-market, it is not surprising that group formation occurs in waves. Given a certain level of development of market and nonmarket institutions, the quasi-market for influence reaches equilibrium. Over time, however, the general economic environment changes and the market equilibrium no longer satisfies the interests of market actors. In such circumstances, there is a period of change, if not turmoil toward a new equilibrium. Once equilibrium is reached again, market actors seek to institutionalize the quasi-market and establish appropriate groups (which do not need to be formal organizations). It is therefore not surprising to see waves of group formation *after* major societal changes. The 1997-1998 crisis in Indonesia is seriously perturbing the quasi-market equilibrium and may very well spark the rise of new organizations in the coming years.

and yet unexplained wave of group formation occurred in the United States between the 1890s and 1920s (which Kenneth Boulding called the "organizational revolution"). This period witnessed a tremendous proliferation of organizations with national reach, whether trade and business associations or other groups.[24] In Indonesia, organized group activity "mushroomed" during the first two decades of the twentieth century. Dwight King hypothesizes that this group activity was the "product of growing division of social labor and the expansion of formal social and political equality."[25]

King's hypothesis is in line with Bentley's argument that groups form out of common interests. Yet, the two crucial pieces of evidence presented above suggest that the pluralist theory does not allow us to make the semantic leap between individual and group interest, at least not as immediately as the theory suggests. We need a theory of group organization that provides a satisfactory description of individual choice in joining and/or forming groups. Does the second paradigm offers such theory?

Olson's Logic of Collective Action

In *The Logic of Collective Action*, Mancur Olson (1965) challenges the pluralist view about group formation and cohesion.[26] Whereas Bentley and other theorists of the pluralist school (such as Commons or Latham) attempt to explain the formation of all groups, Olson limits himself to economic groups. Olson derives fundamentally different conclusions from Bentley's. Whereas the latter emphasizes the identity between individual and group interests, Olson emphasizes a fundamental contradiction in the logic of collective action between individual and group goals and interests:

[24]In the case of the United States, two concomitant trends can explain the "organizational revolution" of the 1890s-1920s. First, technology dramatically expanded the horizons of business and other interests and, second, whether as a result of pressure from market actors or not, Congress enacted legislation of truly national character, seeking to harmonize the various legal and judicial systems inherited from the last states to join the Union, as well as harmonize the legal systems of the former opponents in the Civil War. We suggest that the wave of group formation stemmed from the profound changes brought about by the unification of the country as we now know it and the Civil War. For alternative explanations about the "organizational revolution," see Wilson (1974, pp. 143-170 and 195-214 passim). As mentioned previously, we believe that our quasi-market framework serves as a more appropriate explanation, but it is beyond the scope of this inquiry to develop the argument further.

[25] King (1982a, p. 40).

[26] Olson's Logic of Collective Action opened up an entire field of inquiry. For a review of the literature in the 25 years following the publication of his seminal book, see Sandler (1992).

> Unless the number of individuals in a group is quite small, or unless there is coercion or some other special device to make individuals act in their common interests, *rational, self-interested individuals will not act to achieve their common or group interests.*[27]

Olson reaches this conclusion, exactly the opposite of Bentley's, through his analysis of the key concepts of public (or collective) good and free-riding. For him, beyond the pursuit of common interest, the essence of groups is the provision of "public or collective goods."[28] He observes that when individuals have a common interest in achieving a common goal, this common goal is in fact a public good.[29] In other words, the rewards of collective action must be enjoyed by all the group members if they are to be enjoyed by anyone. From a practical perspective, it means that a group cannot withdraw the benefits of its actions to any of its members. Public goods provide inseparable, general benefits to all group members. It is important to note that the public goods discussed in this study are more restrictive than the economic term entails. Indeed, they are circumscribed to economic goods (such as taxes, subsidies, and regulations) and do not encompass public goods such as national security.

The implication of this public good aspect (of goods produced through collective action) is that members of a group have an incentive to free-ride. Out of rational self-interest, members of a large group realize that they will collect the benefits of the goods even if they don't share the burden of the costs associated with obtaining the public good in the first place. This logic, argues Olson, is inherent in groups and strongly undermines the efficacy of the group's actions (since too many members decide to free-ride). Because of free-riding, certain interests never organize collectively. In Olson's phraseology, they remain *latent.*

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[27] Olson (1965, p.2, emphasis in the original).

[28] Olson (1965, p. 15).

[29] From an economic perspective, public goods are characterized by *jointness of supply* and *nonexcludability*. The former concept refers to the fact that, once produced, any given unit of the good can be made equally available to all. The latter concept refers to the fact that exclusion from the benefit of the good is virtually impossible. The good cannot be appropriated by anybody. In fact, very few goods are completely joint in supply and nonexcludable, but it is a useful way to characterize them. For details, see Samuelson (1954, 1955), Musgrave (1959, 1989), and Head (1962). Olson said that he was particularly indebted to Head in clarifying the two key concepts of jointness of supply and nonexcludability (which Head refers to as "external economies").

Olson's key insight is that free-riding increases with group size.[30] Hence, group efficiency (or effectiveness—in providing collective goods) declines as group size increases. Groups that want to remain efficient need to combat free-riding. Given the negative relationship between group size and group efficiency, it is natural to combat free-riding by limiting group size.[31]

Groups establish various enforcement and monitoring mechanisms to mitigate free-riding. In Olson's framework, these mechanisms are generated within the group and directed at members. They take the form of close monitoring of members' participation and contribution to group activities, strict enforcement of sanctions (coercion) and ostracism against free-riders.[32]

Two additional powerful mechanisms (not suggested by Olson) to preserve group cohesion should be considered. They are generated from external pressure—sometimes at the request of the group leaders to insure group cohesion. First, ethnic minorities may have greater "inherent" group cohesion due to their position as social minorities. For instance, it seems reasonable to assume that Sino-Indonesian groups have greater inherent cohesion than other CPCs because they face such discriminatory treatment in Indonesia. Hence, free-riding may be relatively less prevalent among Sino-Indonesian groups, thereby increasing their efficiency. Second, to enforce cartel agreements or price fixing agreements, cartel members often get the state to assume this task. State support is critical to decreasing the cost of monitoring and punishing free-riding. Given the vastly greater power of the state relative to any other group in enforcing agreements, state support constitutes a powerful mechanism to counter the centrifugal force of free-riding.

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[30]Actually, he also argues that free-riding increases as time elapses, but we will not consider this issue here. Olson suggests three cumulative factors that keep larger groups from furthering their own interests: (1) the larger the group, the smaller the fraction of any group benefit one member receives and, therefore, the less adequate the reward, (2) the larger the group, the greater the likelihood that some members will be able to collect the public good without bearing the burden of providing it, and (3) the larger the size of the group, the larger the organization costs (Olson, 1965, p. 48).

[31]Several authors have questioned the validity to the inverse relationship between numerical group size, on the one hand, and group cohesion and group effectiveness, on the other. Among others: Chamberlin (1974) and Austen-Smith (1981). The latter showed that the relationship between group size and political effectiveness is *ambiguous*. Yet, he also showed that "the individual *unequivocally* offers a lower contribution to group action with higher levels of others' contributions" (Austen-Smith, 1981, pp. 149-150, emphasis added).

[32] For further discussion about how to control free-riding, see Groves and Ledyard (1977).

Because of free-riding, Olson argues, the success of large groups lies in the provision, not of public goods, but of selective incentives (or by-products) to group members. Groups need to provide selective incentives to members if they want to maintain membership. Selective incentives are benefits that can be differentially distributed to, or withheld from, group members, depending on their level of cooperation and contribution to group activities and funding. Without selective incentives, group members would leave the group (or never join) due to free -riding. Hence, as the size of the group increases, it needs to devote increasing resources to the supply of selective incentives, instead of devoting resources to the provision of public goods. There is, therefore, a dichotomy and contradiction between group objectives (seeking to provide public goods) and the objectives of the vast majority of group members (seeking to benefit from selective incentives offered by the group). This dichotomy and contradiction increase as numerical group size increases. The success of large groups, therefore, lies not in the provision of public goods but in an attractive package of selective incentives they offer to their members.

Given the above considerations, Olson stresses the importance of group size as a variable of interest, since the smaller the size, the more effective the group will be at promoting its collective interests.[33] Olson makes two important conclusions. First, group formation is difficult and, second, the result of the conflicting interests of pressure groups is not symmetrical in the polity (which we call quasi-market). In other words, according to Olson, there is no equilibrium in the quasi-market for political influence. Table 2.3 summarizes Olson's key propositions and compares them to Bentley's.

[33]This insight is not new however. For example, in 1937, Herbert Heaton, commented as follows on the incentive to rent-seek: "The incentive rarely came from a whole class, for a class was too unwieldy, too class-unconscious, and too much torn by conflicting factors or interests to have one will or voice. Action came from individuals or *compact groups* who saw an opportunity to profit by protection or promotion." (Heaton, 1937, p. 387, emphasis added.) What is new in Olson's model is the combination of this insight about the need for groups to be small to further their interest, with the insight that the essence of groups lies in the provision of collective goods, and hence that groups are subject to free-riding.

Table 2.3

Key Group Attributes in Bentley's and Olson's Models

	Bentley's Model	Olson's Model
Group formation	Easy (out of shared interests)	Difficult (because of free-riding) Need political entrepreneur*
Group cohesion	Easy to maintain (out of shared interests)	Hard to maintain (because of free-riding) Need political entrepreneur*
Group objectives	Identity between individual and group objectives	Fundamental contradiction between individual and group objectives. Small groups can manage the contradiction, large groups must resort to granting selective incentives.
Group's political effectiveness as a function of its size	Increases	Decreases (because of free-riding)
Effect of group political activities on overall efficiency	Positive	Negative and can lead to social paralysis and no-growth (Olson, 1982)
Equilibrium in quasi-market for political influence?	Yes	No (quasi-market is not symmetrical)

* Point made by Wagner (1966), Wilson (1974), and Moe (1980).

Because of free-riding and the necessity to provide selective incentives, many interests are never organized into pressure groups, and the groups remain latent. Olson is concerned mainly with the formative stages of group activity, prior to formal organization. He does not elaborate on the conditions and processes leading to the formal organization of groups. The question is of particular relevance when we consider that, at the genesis of a group's existence, the group has very little selective incentives to offer and, supposedly, it relies on the higher objective of providing public goods to attract its first members.[34]

Many authors have criticized Olson for this oversight.[35] The most common, and most convincing model of group formation is that of the political entrepreneur. With respect to Olson's theory, the model was first proposed by Richard Wagner in his review of Olson's *Logic of Collective Action.* Wagner suggested that groups form under the leadership of political entrepreneurs who see a prospective dividend that could stem from the organization of interests. Hence, for a price (e.g., in votes or glory or other perks), the political entrepreneur takes the responsibility of organizing the group. In Wagner's view, and to quote Shepsle and Bonchek, "if selective incen-

[34]Argument made by Wilson (1974, pp. 195-196).

[35]Among others: Wagner (1966, pp. 161-170 passim), Wilson (1974, pp. 195-214 passim) and Moe (1980, pp. 5-9 passim).

tives *resolve* the paradox of collective action, then political entrepreneurs *dissolve* the paradox."[36]

Without going so far as to say that political entrepreneurs dissolve the paradox of collective action, Terry Moe offers a formal model of the political entrepreneur, which does not depart in any fundamental way from Wagner's simpler model.[37] Because the solvency of the group is the *sine qua non* condition for the provision of both collective and private goods to its members, the fundamental task of the entrepreneur is to ensure the group's survival and, therefore, combat free-riding. In the quasi-market of influence, the political entrepreneur can be viewed, as an economic entrepreneur in a private market.[38] He invests capital in a set of benefits (collective goods and selective incentives) that he sells, for a price, to potential members. For our purpose, the most important aspect of Moe's model is his discussion of the three basic elements which shape the entrepreneur's incentives.

First, the entrepreneur must, over the long run, be able to show positive results and successes (or reasonable expectations thereof) in providing collective goods, so as to maintain the support of core group members (who are interested in the collective good and, hence, are not free-riders). Second, the entrepreneur may want to obtain collective goods because they are of direct material benefit to himself. Third, political activity may enhance his ability to provide selective benefits.

The application of the model to CPCs is immediate. CPCs come into existence only under the leadership of one or a very small group of political entrepreneurs who seek to obtain collective benefits that provide them with direct material benefits. To achieve these objectives, the close proximity of the entrepreneur to the decisionmakers is crucial. The support of core group members is also vital to the survival of the group. In our analysis of Indonesian CPCs, we have not been able to single out the political entrepreneurs leading each CPC, but we suggest potential candidates (e.g., Liem Sioe Liong or Bob Hasan for the Sino-Indonesian CPC, and Bambang, Tutut, or

[36] Shepsle and Bonchek (1997, p. 246, emphasis in the original).

[37] Moe (1980, pp. 36-72).

[38] We have seen in the previous section the dynamic and positive role played by the Schumpeterian entrepreneur in the process of creative destruction.

Probosutedjo for the Suharto and kin CPC).[39] It is important to note that these entrepreneurs are interested in the provision of public goods (e.g., a system of license or import and export monopolies), because they derive private benefits from these goods.

The second fundamental conclusion made by Olson is that the conflicting interests of pressure groups are not, to use his term, symmetrical.[40] By this, Olson means that small interest groups have disproportionate power and capture most of the public goods traded in the quasi-market for influence. In contrast, the majority of groups in society—large or latent—do not have their interests represented proportionally to their numerical size and capture few public goods. In the case of latent groups, they never form. This conclusion has the seeming advantage not to contradict the empirical findings of, for example, Schlozman and Tierney. Thus, according to Olson, there is no equilibrium in the quasi-market for political influence. Yet Olson does not describe the conditions of change in the quasi-market, whether toward or away from any type of equilibrium situation.

We are perplexed by, and dissatisfied with, this conclusion. Olson suggests a world in which business interests, if not all groups of society, would continuously be faced by a situation in which their interests are not adequately represented. In a quasi-market for political influence, there is a price attached to the goods produced by the quasi-market. Just as for any market, different consumers have different utility and different valuation of the goods offered in the market. Even if most consumers cannot purchase the goods they would like to, it does not follow that markets are not in equilibrium. In the extreme, even if many consumers do not even enter into a market (because the level of prices is too high for them), it does not follow that the market is not in equilibrium. Rather than recognizing this basic element of economic behavior, Olson seeks to explain the paradoxical logic of collective action by relying solely on the concept of free-riding. Free-riding, however, is only a market failure in the quasi-market for influence. Market failures may lead to sub-optimal

[39]Liem Sioe Liong, Sudono Salim by his Indonesian name, is the owner of the Salim group, the largest conglomerate in Indonesia. Bob Hasan is the owner of the Nusamba group, which is ranked as the seventh largest conglomerate (see Table 3.2). He was also appointed Trade Minister in the Seventh Cabinet. Both are very close friends of President Suharto. Bambang, Tutut, and Probosutedjo are son, daughter, and half-brother respectively of the President.

[40]"The outcome of the political struggle among the various groups in society will not be symmetrical." (Olson, 1965, p. 127.)

equilibrium outcomes (underproduction and overprice), but they should not lead to continuous disequilibrium. We discuss this and other issues further in the upcoming section on our model of choice (Gary Becker's).

Before presenting a taxonomy of groups that better describes CPCs, it is worth highlighting three of Olson's contributions. First, whether ambiguous or negative, there is a crucial relationship between numerical group size and the level of collective activities carried out by the group. Moreover, it is unequivocal that free-riding increases with group size. Hence, CPCs must be able to limit their numerical size to be effective.

Second, to counter the centrifugal force of free-riding, groups establish various mechanisms to mitigate free-riding's perverse effects on group effectiveness. These mechanisms can be devised within the group, but they can also result from the environment in which groups operate. For instance, CPCs composed of ethnic minorities, like Sino-Indonesian, may suffer less from free-riding and, hence, *ceteris paribus*, have greater effectiveness than other groups. Similarly, CPCs can seek the support of nonmarket actors in monitoring and enforcing economic arrangements that provide CPC members with rents. Price-fixing or organized cartels condoned and established by the state allow CPCs to dramatically increase their effectiveness. As such, CPCs actively seek to influence nonmarket actors to provide them with such support.

Third, Olson devotes little time to the issue of group formation *per se*. His focus is on the formative stages of groups, which is exactly the state most CPCs today's emerging markets are in. Models using the metaphor of the Schumpeterian entrepreneur to describe the leadership role of founders and organizers of groups (e.g., Wilson's or Moe's) are promising. These models suggest an entire line of inquiry centered around the identification of CPC leaders. It is beyond the scope of this study to go to great length at identifying these entrepreneurs, but it is clearly an area for further research.

With respect to our question of *why influence as a group*, the previous models provide the following answers. First, whereas Bentley suggests that the *raison d'être* of groups is to pursue common interests, Olson concurs only with respect to small groups. Olson suggests that, beyond the pursuit of common interests, the essence of

groups is the provision of public goods. The free-rider problem requires large groups to offer selective incentives to their members. In contrast, small groups are able to focus more on the provision of public goods and less on combating free-riding. Hence, everything else equal, small groups are more efficient than large ones. Second, whereas Bentley emphasizes the ease with which groups form (they spring out of common interest), Olson stresses the difficulty of group formation. Beyond a certain size, groups cannot form at all; they remain latent.

Taxonomy of Economic Interest Groups

Based on the foregoing discussion, we present a taxonomy of groups that best describes what type of groups CPCs are. As we have seen in the previous section, CPCs are economic pressure groups (business groups for short), seeking rent. Despite the pervasiveness of business groups, however, very little is known about them. As Terry Moe remarked: "the fact of the matter is that business groups have rarely been systematically studied."[41] Despite scant study, three characteristics of business groups stand out.

First, except for general business associations, business groups are small in size (fewer than 50 members) and are highly specialized and focused on the defense and promotion of very narrow interests. Second, all the evidence suggests that members of business groups join them for "political reasons"—i.e., to influence policy—which is not true for members of most other groups. Third, there is an apparent dichotomy between, on the one hand, general business associations and, on the other, firms and trade associations (trade associations for short). We focus on this dichotomy to better describe CPCs.

General business associations claim to represent large parts of the business community, whereas trade associations are much more narrow in focus. With respect to size, the former are quite large, while the latter are quite small. In terms of the type of interests they defend, general associations focus on big policy issues—e.g., the promotion of deregulation of entire industries—while trade associations focus on narrow questions of direct importance to their members—e.g., regulations regarding the types of dyes that can be used in silk weaving. Finally, general business associa-

[41] Moe (1980, p. 192).

tions seem to only attract a small percentage of the members (typically, the largest firms) they purport to speak for, while trade associations are usually inclusive of most firms of the particular segment of industry they represent.[42]

Given these characteristics, according to Olson, business interests as a whole are not very well represented, while interests of smaller industrial segments are very well represented by highly focused organizations. Trade associations, although smaller than general business interests, still need to fight free-riding and provide selective benefits to their members such as trade statistics, credit references on customers, technical research, advisory services, and so on.[43] Relative to trade associations, general business associations are not very effective pressure groups because, confronted with free-riding, they do not attract the direct support of the whole business community. They do not provide their members with attractive selective incentives like trade associations do.

According to Olson's model, general business organizations should not even exist; they should remain latent. Yet they do exist and have been around for over a century. Furthermore, they have been quite successful at maintaining their membership. Olson explains the apparent inconsistency by suggesting that, although large and usually unable to offer appealing selective incentives, large business groups function like small groups. For example, he points to the fact that although NAM has several thousand members, in practice, it is controlled by a few large companies. Historically, about 5 percent of membership have paid half the money and 0.8 percent of NAM members have held 63 percent of all directorship positions.[44]

Wilson disagrees with this interpretation and point out, instead, that even NAM's "small" group (which Olson refers to) is composed of about 1,000 companies—hardly a small group.[45] Wilson suggests that both small and large companies actually share

[42]Two examples of general business associations are the NAM (National Association of Manufacturers) and the Chamber of Commerce. The NAM only comprises between 6-8 percent of all manufacturers, while the Chamber of Commerce only attracts about 10 percent of all local chambers of commerce. See Olson (1965, pp. 141-148 passim), Wilson (1974, pp. 153-167 passim), and Moe (1980, pp. 192-200 passim).

[43] Olson (1965, p. 145).

[44]See Olson (1965, pp. 146-147), based on Dayton D. McKean, *Party and Pressure Politics* (Boston: Houghton Mifflin, 1949, not consulted by the author, HPL).

[45]According to Wilson, the 8 percent of members who pay half the dues total roughly 1,000 firms. (In a decade, the share of members who paid half the dues increased from 5 to 8 percent.) See Moe for a discussion of both Olson and Wilson arguments (Moe, 1980, pp. 191-199 passim).

the same objectives, but the latter are more active in NAM because they can better afford membership dues:

> To the very largest corporations, the cost of NAM membership, even at the highest dues quota of $65,000 a year, is trivial; they constitute, therefore a stable core of membership. ... For the smaller firms, the dues even at the lowest rate of $200 per year, are not trivial.[46]

Wilson also remarks, like Olson, that NAM and the Chamber of Commerce actually offer few selective benefits to their members. He attributes the success of these organizations to their reliance on *purposive* incentives to attract members. Purposive incentives are "intangible rewards arising out of the act of associating that can be given to, or withheld from, specific individuals [i.e., they are private goods]. Indeed, their value usually depends on the fact that some persons *are* excluded from their enjoyment. They include offices, honors, and deference."[47] Thus, according to Wilson, large corporations spend high membership fees and devote resources to NAM and the Chamber of Commerce just to derive some intangible returns (like honors and deference). In his view, corporations seek private rewards through more focused trade associations and seek intangible rewards through general business associations.

Just as we were perplexed and dissatisfied with Olson's conclusion that there is no equilibrium in the quasi-market for influence, we are perplexed and dissatisfied with the explanations of both Olson and Wilson regarding the differences between general business and trade associations. Olson is caught up in his own over-emphasis on the issue of size (Olson never says what the threshold between small and large is), while Wilson is not convincing in attributing "purposive incentives" to the attractiveness of large business associations.

These unsatisfactory results stem, in Olson's case, from an exclusive focus on size and free-riding, and his sole focus on the distortionary effects of influence-seeking, without due consideration to the fact that market actors also seek efficiency, thereby countervailing their own political power. Wilson's conclusion is unsatisfactory as well, because it fails to capture the fact that corporations may be seeking to promote and protect narrow industry-specific interests through some trade associations,

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[46] Wilson (1974, p. 157), cited in Moe as well (1980, p. 194).

[47] Wilson (1974, pp. 33-34, emphasis in the original).

while seeking to affect wider economy-wide interests through general business associations. No corporation would seek to change the overall business environment on its own (assuming it could), because the product of such action would clearly be a public good that all firms could enjoy.

We suggest instead that large corporations decide to join and to carry a disproportionate burden of the costs of NAM's or the Chamber of Commerce's activities because the general purpose of these organization serves their diversified interests. Within, say NAM, large corporations can "speak for business" as long as there is a non-negligible membership held by smaller firms. Large corporations join and support trade associations to promote and protect narrow interests and join general business associations to promote and protect a business environment that they consider more adequate to business interests. For example, NAM is the best platform to voice concerns against trade union power or overwhelming environmental regulation, whereas trade associations are more appropriate to protect narrower interest like, say, regulation of the disposal of chemical waste in the photographic industry. Although smaller corporation free-ride on the efforts of the core group of large manufacturers, the latter are ready to assume the burden because they would disproportionately reap more benefits from a change in overall economic environment than smaller firms which are more concerned with issues of immediate impact on their activities.

Both Olson and Wilson are correct, however, in pointing out that NAM and the Chamber of Commerce are not very effective organizations because they are so large. To be effective (i.e., to be able to obtain many public goods through political influence), groups need to remain small and successfully combat free-riding. Among small groups, Olson makes an interesting distinction between *privileged* and *intermediate groups*. Both are small and highly efficient groups. They are successful organizations because one group member (the privileged group) or a few group members (the intermediate group) are able to provide all the collective goods the group seeks to obtain in the quasi-market. These group leaders (i.e., the group's political entrepreneurs described above) accept to share the collective goods because they cannot withhold them from other members; yet, they could not derive the goods in the first place if they were not at least pretending to speak for the group or society as a whole.

We combine both taxonomies and suggest that CPCs are *small (privileged or intermediate) groups of large firms or conglomerates engaged in activities akin to general business associations.* In modern Indonesia, an example of a privileged group is the CPC of President Suharto and his family, and the Sino-Indonesian CPC is an example of an intermediate group with a few leading business tycoons obtaining and maintaining an economic system of rents and monopolies to the benefit of all the members of the CPC, including themselves.

Conclusion

We can summarize the two sections we have devoted to the *why influence* and *why influence as a group* questions, by saying that, in essence, CPCs are mega-rent-seekers. They are small groups of large firms or conglomerates engaged in activities akin to general business associations. Their effectiveness in influencing policymaking and obtaining the rents they seek is a function of (1) their aggregate size in the economy, (2) their numerical size, and (3) their cohesiveness. Although size and cohesiveness are positively related, the correlation between them can differ according to the relative effectiveness of groups at combating free-riding and the specific environment the CPC faces (e.g., a CPC composed of an ethnic minority is, *ceteris paribus*, more cohesive and hence more effective than other CPCs).

After going to relatively great length to explain why CPCs act collectively and seek to influence policymaking, we feel that we are justified in making two crucial assumptions related to the CPC-based analysis. Yes, it is legitimate to infer the interests of CPCs from those of individual firms because there is commonality of interests between the two—as long as the CPC remains of small numerical size (which they are by construct). The relative size of a CPC is a matter of judgment. And also, as a flip side of the first point, it is legitimate to aggregate firms with common characteristics into CPCs, since we have shown that they would have congruent interests.

Commercial Power Centers are thus the largest and most important players of the demand side of the quasi-market for political influence on economic policy. Their involvement in the market and their willingness to pay nonmarket actors for economic policy is a function of the attractiveness of the returns they expect from their political activities. We review what they seek to obtain through political activities in the next section.

WHAT TO INFLUENCE?

Having addressed the closely related questions of why CPCs seek to influence policy and why they choose to do it on a collective basis, we now turn to the question of *what* CPCs try to influence. The answer to the question can be partially derived from the definition of CPCs and from the answers to the *why* questions. Within our framework of a quasi-market for influence, CPCs seek to influence nonmarket actors to derive economic rents. They seek to institutionalize the rents they receive through a structure of taxes, subsidies and economic regulations that protect or promote their economic interests.

Our definition of CPCs suggests a partial answer to the question of what CPCs seek to influence: CPCs try to influence the design and implementation of government economic policies to suit their diversified economic interests. Regulation and other economic policies define the institutional framework within which CPCs perform their activities. An entire literature on economic regulation (referenced below) examines how and to whose benefit economic regulation is enacted.

To simplify, there are two views on the subject. The first view is referred to as the public interest view. It suggests that regulators pursue society's common interest in seeking to address market failures (mainly by regulating monopolies) and supplying public goods (e.g., national defense or education). In this view, the regulator acts in favor of the public interest. The second view constitutes what is referred to as the public choice paradigm, supported either by the so-called capture theory (political science) or by the theory of economic regulation (economics). It suggests that regulators enact regulation not for the common good, but to the benefit of the regulated industries themselves. In this view, through various political (lobbying) activities, the regulated industries obtain regulations that are to their benefit. The public choice paradigm suggests formal collusion or informal collaboration between the regulated and the regulators. Whereas the justification for the former view focuses on the social justification for preferential action, the latter view focuses on the alleged self-serving character of the preferential action itself.[48]

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[48]It must be recognized that any economic regulation is "preferential" inasmuch as it requires specific and targeted reallocation of resources, and as it has consequences—positive or negative, and to varying degrees—that differentially affect all economic actors. Hence, the discussion about government regulation centers around the justification for taking preferential action. (See Wolf, 1993, pp. 35-37).

A whole school of economists from Chicago (George Stigler, Sam Peltzman, Richard Posner, and Robert Barro among others) examined public regulation in many industries—e.g., utility, oil, communications, transportation, and commercial banking.[49] The Chicago economists developed a theory of economic regulation that formalized the various capture theories of political science.[50] Because it is well formalized, we rely on the theory of economic regulation to present the public choice paradigm. The conclusion of the theory of economic regulation rejects, both on theoretical and empirical grounds, the public good justification and instead suggests that the chief beneficiary of regulations is not the consumer but the regulated industry itself.[51]

The theory of economic regulation is a supply and demand model for economic regulation, which applies cartel theories from the economic literature to the regulatory process. On the demand side of economic regulation, market actors seek to "purchase" regulation because they want to buy the one commodity the state holds a monopoly on: the power to coerce, to prohibit or compel, to take or give money.

There are four types of regulation market actors seek to purchase:

(1) Direct subsidies or preferential tax treatment
(2) Control over entry by new rivals in industry
(3) Regulation against substitute goods and in favor of complementary goods
(4) Price-fixing.[52]

The four types of regulation constitute rents that accrue to the beneficiaries of a specific regulation.

Although direct subsidies or preferential tax treatment are the most direct forms of rents that market actors can receive, they are attractive only if the list of beneficiaries

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[49]Among the most important contributions, we would cite: "The Theory of Economic Regulation" (Stigler, 1971), "Taxation by Regulation" (Posner, 1971), "The Control of Politicians: An Economic Model" (Barro, 1973), "The Social Costs of Monopoly and Regulation" (Posner, 1975, which is also a classic article on rent-seeking), and "Toward a More General Theory of Regulation" (Peltzman, 1976).

[50]For a summary and critique of the capture theories from political science, see Posner (1974). Richard Posner (1974, p. 335) remarked that the capture theories attracted an "odd mixture of welfare state liberals, muckrakers [*à la* Ralph Nader], Marxists, and free-market economists."

[51]The best theoretical treatment of the question can be found in Peltzman (1976) and in Posner (1975). The empirical evidence they review is based on the analysis of the regulatory framework in, among others, the cable, utility, and trucking and railroad industries.

[52]For details and examples, see Stigler (1971, pp. 4-10) and Posner (1971, pp. 34-47).

can be limited. If not, over time and given the finite amount of fiscal resources, competition for a subsidy (or preferential tax treatment) will lead to a decrease in the amount each firm or industry receives.[53]

Control on entry into an industry is a powerful mechanism to reduce competition and to maintain the monopoly profits that can be derived in an industry with few players (oligopolists). As mentioned already, enforcement of cartel agreements by the state is the most powerful means to secure the cartel over time. Empirical evidence suggests that "every industry or occupation that has enough political power to utilize the state will seek to control entry."[54] Several industries have been very successful at obtaining favorable regulation of entry, which effectively assures the existing companies a monopoly position. A variant to this direct control on entry is a system of protective tariffs that favor domestic producers.

Regulation against substitute goods and in favor of complementary products is also very common. Producers will typically seek to obtain such regulation. As Stigler puts it: "butter producers wish to suppress margarine and encourage the production of bread."[55]

Finally, the last common type of regulation that economic pressure groups seek to obtain is price control. Price fixing is often used in addition and as a complement to restrictions on entry. As we pointed out earlier, private cartel agreements seeking to fix price tend to unravel rapidly, whereas price fixing enforced by nonmarket actors (e.g., price of electricity) can last for very long periods of time.

Most of the empirical evidence gathered and analyzed by the Chicago economists reveals that, across industries, the structure and outcome of regulation favor the regulated industries themselves. Yet, this theory of economic regulation is not wholly satisfactory for three main reasons.[56] First, although better formalized than the various versions of the capture theory, the evidence gathered by the Chicago economists is consistent with any versions of theories which assert that the regula-

[53] As shall be shown in the next chapters, in Indonesia as in the mercantile system, the awarding of monopoly rights is often used instead of direct subsidies.

[54] Stigler (1971, p. 5).

[55] Stigler (1971, p. 6).

[56] For a candid and detailed critique of the theory by one of its prominent members, see Posner (1974, pp. 352-356). For a review and critique of the theory, see Rothenberg (1995, pp. 299-318 passim).

tory function of government does not favor the public good but rather favors the regulated actors themselves. For instance, the evidence supports both Marxist and free-market theories. Since the so-called theory of regulation can accommodate many contradictory interpretations, it is more akin to a broad hypothesis than to a fully-fledged theory.

Second, the empirical research to prove the theories has not been systematic. Only heavily regulated industries were chosen as case studies, and no attempt was made to explain why some industries are less regulated than others. Similarly, the case studies only focused on economic regulation, without paying attention to other types of—non-economic—regulation that have an important impact on economic welfare. For example, some aspects of environmental laws and regulations (e.g., emission controls, safety regulations) or criminal and civil laws protecting consumers from abuse (e.g., truth in advertising and packaging) have economic consequences, yet they were not systematically reviewed by the Chicago economists.

Third, due to these shortcomings, it appears that the rejection of the public interest justification of government activities is sometimes questionable. In addition to the examples of non-economic regulation in the previous paragraph, the theory cannot explain the adoption of economic regulations addressing market failures to the detriment of business interests (e.g., environmental taxes that address the negative externalities associated with pollution). Such regulations support the public interest view of economic regulation.

In addition to these shortcomings regarding the demand for economic regulation, the theory is of little relevance to emerging markets with respect to the analysis of the supply of regulation. Indeed, the behavior of the suppliers of economic regulation—i.e., nonmarket actors—is explicated with vote-trading and other types of political support mechanisms characteristic of liberal democracies. On balance, despite some interesting insights and empirical evidence showing that regulation is often enacted to the benefit of the regulated industries themselves, the theory of economic regulation falls short of providing a coherent model of the quasi-market for political influence. Can the theory be reconciled with the public interest view of regulation? When it seems that regulation is to the benefit of the common good, does it mean that we should consider the regulators as benevolent actors, or are they still the transmitters of some pressure from interest groups? In the realm of economic regu-

lation, are there instances in which economic pressure groups lobby in favor of policies that enhance efficiency and against their narrow, immediate and vested interests? If so, why?

As shall be shown in the empirical chapters, market actors sometimes seek to prod local rulers to address nonmarket failures and provide an institutional regulatory environment which supports business development. Nonmarket failures stem from a lack of economic regulatory legislation and institutions, which provide the necessary environment for markets to function.[57] Business groups, in addition to narrow interests, also have vested interests in the development of nonmarket institutions to support their commercial activities. Beyond the pecuniary benefits of the rents they could extort from nonmarket actors, they also have a vested interest in the overall development of a nonmarket sector that could adequately grant and protect rents.

It is the desire to shape this institutional framework that motivates today's CPCs as well. CPCs need to make strategic choices as to which market failures they will seek to address (e.g., through horizontal conglomeration to create internal markets where price mechanisms and information flows function reasonably well), and which market failures they will request nonmarket actors to fix for them. They have to make similar decisions with respect to market failures that they want to perpetuate or help generate (e.g., monopoly rights or distorting subsidies).

Similarly, CPCs also make strategic decisions as to which nonmarket failures they will lobby to have fixed (e.g., an overly cumbersome bureaucracy overseeing exporting activities) and which ones they will lobby to maintain (e.g., an overly cumbersome bureaucracy overseeing imports of competing goods).

CPCs thus need to do a balancing act between promoting and supporting policies that are distortionary in nature, while at the same time, promoting and supporting policies that enhance efficiency and, in time, economic growth. The intuitive reason for this logic is that CPCs cannot simply seek to maximize the amount of rents they derive from the system. If they did, in time, they would destroy the very system that provides them with rents. Mancur Olson offers an interesting analogy to illustrate

[57] In essence, nonmarket failures are performance shortfalls, by nonmarket actors, in addressing market failures and providing public goods. (See Wolf, 1993, pp. 35-102 passim.)

this conundrum.[58] Olson compares the behavioral incentives of an individual criminal with those of organized crime. Although, other things being equal, a criminal is best off in a rich country, his incentives are such that he is led to steal, thereby reducing wealth. Indeed, in a society of say a million people, the thief only bears about one-millionth of the total loss to society that his theft generates. This loss, however, is trivial compared to the opportunity cost of not stealing. If he chooses not to steal, he alone bears the cost of lost opportunity. Therefore, the thief has the incentive to steal as much as he possibly can.

The incentives of organized crime, however, are very different. Assume that an organized crime syndicate is able to monopolize theft in a given neighborhood. Like any monopolist, it does not want to share the spoils and does not allow any theft to take place in the neighborhood. Moreover, because crime reduces net wealth, the organized syndicate with a monopoly on theft in a neighborhood "*will not commit any robberies at all.*"[59] Instead, the syndicate will organize a racket system (i.e., organized robbery) by which it will extort payments for protection: (1) against the crimes it would commit if racket dues were not paid and (2) against the crimes that other criminals want to come and commit in the neighborhood. Clearly, the more prosperous the neighborhood, the higher the rent the syndicate can extort from the inhabitants.

This analogy is striking when transposed to the conundrum facing CPCs. If the CPC has truly monopoly rights over an activity, it will be in its interest to limit the plundering of resources and instead promote a prosperous industrial activity so as to derive more rent. Yet, if there is intense competition among CPCs in a particular segment of activity, then each CPC will have incentives similar to those of the individual thief—it will try to steal whatever it can. In the case of Indonesia, as long as the Sino-Indonesian CPC was essentially alone to compete for rents, it had an interest in refraining from too egregious exploitation of the system (their sociopolitical precarious situation, of course, contributed to this). Concomitant with the economic boom of the 1986-1997 years, members of the first family and various

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[58]Olson (1997, pp. 40-43).

[59] Olson (1997,. p. 41, emphasis in the original). This is only the case if the crime syndicate truly monopolizes theft in a given neighborhood. Without such monopoly, many individual thieves would all have the same incentive—steal as much as possible, and the neighborhood would become highly crime ridden.

pribumi entrepreneurs entered *en force* the quasi-market for political influence. The competition for spoils increased rapidly and, by the mid 1990s, had reached a situation more akin to a city full of individual thieves than one controlled by one organized crime cartel.[60] The solution to the "thief dilemma" is to develop representative institutions that perform arbitrage among the thieves' competing interests.

To sum up, although the Chicago school of economists has developed a theory of regulation, accompanied by a compelling body of empirical evidence, the theory is not fully satisfactory. The theory describes well what types of regulations and policies business groups seek to promote, but the theory is not able to explain examples of government regulations addressing market failures to the detriment of some of these groups. The theory does not allow for the possibility that the political activities of business groups can sometimes lead to the adoption of economic policies that are detrimental to the narrow economic interests of some of these groups, yet promote overall economic efficiency.

Becker's model, in contrast to the Chicago school, predicts this outcome under certain circumstances of competition in the quasi-market of political influence (see in the section devoted to Becker's model). Olson's crime analogy suggests that a monopolistic group has vested interests in seeking to limit and control its rent-seeking—racketeering in his analogy—activities. The level of competition in the quasi-market for political influence seems to be the key to resolving the conundrum.

HOW TO INFLUENCE? THROUGH WHICH CHANNELS?

Answering the question of *how* and *through which channels* CPCs influence policy is the most difficult of our three key questions, and it is the least amenable to a theoretical construct. The existing descriptions of the activities of economic pressure groups (lobbies) pay extensive attention to the particular context of each country.[61] These descriptions are not very relevant to the case of Indonesia—nor for that matter to many other emerging markets which are characterized by a *constitutional liberal-*

[60]Many Indonesian observers see the death of President Suharto's wife in April 1996 as the beginning of an era of unrestrained greed by the first family members. She used to carefully balance the various interests of her children, whereas Suharto is known for his "soft spot" in favor of his children, in particular Tommy, his youngest son.

[61]For an excellent work on contemporary Western Europe and America, see Schmitter (1981).

ism that is still in its infancy.[62] Constitutional liberalism (meant to protect individual rights) is composed of a rich set of institutions and mechanisms for channeling private interests to the polity, as well as institutions and mechanisms designed to allow policymakers to implement policy. Today's emerging markets are in the process of developing these institutional arrangements, just as medieval and mercantile Europe did over the course of several centuries (see next chapter).

In the absence of well-functioning institutions and mechanisms, personal channels of influence are more important than institutional ones. Yet the process of developing the institutions of constitutional liberalism does not mean that there is an unequivocal movement toward the institutionalization of channels of influence. Even in western democracies, personal channels of influence remain important conduits for private individuals to reach policymakers—as attested by multiple scandals in Western Europe over large-scale bribery for weapons contracts, in Japan over large-scale bribery of many politicians, or in the United States with illegal campaign contributions.

The analytical inquiry is further complicated by two facts. First, among all channels of influence, personal channels of influence are the most contextual (specific to each country and type of policy to be influenced), and pressure groups have reason to hide the mechanisms they use to access and influence policymakers. Second, to be relevant, any taxonomy of channels of influence may require the analyst to go into great detail to describe these channels—e.g., family, ethnic group, political parties—and the methods utilized to influence policymakers—e.g., campaign funding, open or covert; mobilizing voters; bribery; threats or promises about new businesses, scale of operations, or moving businesses or production; etc.[63] Such analysis is better done on a case-by-case basis than as a formal taxonomy.

As a general rule, it can be said that economic pressure groups will seek to the fullest to "work the system" to promote or protect their interests; and they will often try to do so by invoking the greater good of society. Herbert Heaton summarized as follows the activities of mercantile rent-seekers:

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[62]On the discussion about constitutional liberalism and democracy, see Fareed Zakaria's article in *Foreign Affairs* (1997).

[63] See Treverton, Levaux and Wolf (1998, pp. 5-6.)

> They [rent-seekers] would appeal to patriotic or social ideals, and point out the harmony between the expected enhancement of their own income and the furtherance of the national good or the swelling of the king's income; they would exploit the growing antipathy toward the foreigner; they would use their full weight in parliament or at court to drive a proposal through; or they would bribe courtiers, send gifts to the king, and offer to split the profits fifty-fifty. They had nothing to learn from the modern lobbyist.[64]

Close scrutiny of contemporary economic pressure groups, whether in developed or developing countries, suggests that rent-seekers are still as imaginative as they were in the low Middle Ages.

Although they will use any channel of influence they deem appropriate for the task—and perhaps use several channels in a barrage of political activities—there seems to be a general movement from personal to institutional channels of influence, coinciding with the development of institutions and mechanisms associated with the rise of constitutional liberalism. In essence, economic pressure groups can influence policy through the three main governmental channels: executive, legislative, and judiciary. Depending on how well the branches of government function and how well they are separated, pressure groups have more ways to access policymakers than in a system with a single ruler. Just as in economic life, specialization is a never-ending process in institutional development. New channels of influence appear, while others become extinct as institutions mature.

Influence through the executive and the judiciary notwithstanding, it appears that, within constitutional liberalism, the central clearinghouse in the quasi-market for political influence is Parliament (or Congress).[65] In Indonesia (at least until the political crisis of May 1998), the Parliament played a minor role and most of the arbitrage among contending claims for political influence was performed by the President himself.

It was thus perfectly rational for the Indonesian President to seek to limit the number of CPCs he faces. It was especially useful to deal with an economically powerful, but politically hamstrung, CPC (the Sino-Indonesian conglomerates). The precarious-

[64] Heaton (1937, pp. 386-387).

[65] See the historical chapter below. Also, Barry Weingast and Mark Moran's work (1983) on the Federal Trade Commission concluded that, despite appearances to the contrary, the Federal Trade Commission (FTC) is working under close supervision of its congressional oversight committees and that, accordingly, policy changes at the FTC resulted from changes in the composition of these committees and not from direct political influence on the FTC.

ness of Sino-Indonesians in Indonesian society greatly mitigated their political power—all to the benefit of then President Suharto. As we shall see in the section on English wool trade, however, a single absolute ruler faces increasing difficulty in performing this role, as interests become more complex.

Regardless of which channel of influence pressure groups use to reach policymakers, they need to establish linkages with them. These linkages can be at either the *local* or the *national* level and can be of the following *types*:[66]

- Formal linkages (when the linkage is established through social organizations, such as professional colleges, or business associations)
- Functional linkages (when a member of the CPC is appointed to a public portfolio)
- Forced linkages (when the linkage is forced by social mobilizations, such as strikes or anti-government protests)
- Electoral linkages (when the CPC funds political campaigns)
- Corruptive linkages (when the CPC "contracts" services from the officials astride one of the channels or, less egregiously, offers shareholding to relevant government officials).

Despite the limited information available on which channels of influence each CPC uses in Indonesia, we will endeavor in the case study to identify them. As a preview of the policy implications we discuss in the final chapter, both the intelligence community and international lending agencies would understand local policymaking much better if they collected information on these channels and links between policymakers and CPCs.

INITIAL CONCLUSIONS

The answers to our three key questions of interest have revealed the general characteristics of the quasi-market for political influence on economic policy. The answers to the *why influence* and *why influence as a group* questions indicate that CPCs are market actors on the demand side of the quasi-market. They are—formally or informally—organized groups of rent-seekers, who devote scarce resources to the pursuit

[66]Treverton, Wolf, Levaux (1998, pp. 5).

of rents granted by governments. Rents are defined as streams of revenue stemming from preferential economic policies or regulations that promote or protect CPCs' interests.

The main thrust of the answer to our *why influence as a group* question comes from Mancur Olson's work on collective action. His insights about the importance of small numerical group size and the need to combat free-riding are of great importance to an evaluation of the political effectiveness of CPCs. In terms of group cohesion, Olson's conclusions are relevant to CPCs in emerging markets. In terms of group formation, however, his insistence on the difficulty of group formation (because of the inherent problem of free-riding) is a result of his excessive emphasis on the issues of size and free-riding. More important, this over-emphasis on group size and free-riding leads him to conclude that the quasi-market for political influence is asymmetrical; it does not reach equilibrium and, hence, it does not clear. We disagree with this view and present a more useful way to model the conditions leading to equilibrium that exists in the quasi-market in the next section .

The main thrust of the answer to our *what to influence* question comes from the work of the school of Chicago economists who closely looked at the issue of regulation. The empirical evidence confirms that, in many cases, regulation works to the benefit of the regulated industries themselves, and not to the public interest's. Yet there are instances of policies directed at improving economic efficiency (by fixing market failures and providing public goods) in favor of the public interest. The proponents of the theory of economic regulation do not provide an adequate answer to this conundrum.

Finally, our answer to the *how to influence* question remains very superficial at the theoretical level for two reasons. First, the nature of the question makes it difficult to provide an adequate theoretical construct that is general enough to apply to several countries. Second, CPCs are not eager to advertise the channels of influence they use to access policymakers. Regardless of these limitations, we suggest a trendline of influence-seeking centered around the concept of constitutional liberalism. As a country's institutions and mechanisms become more diversified and rich, CPCs and other interest groups rely more and more on institutional channels of influence rather than on personal ones. Nonetheless, CPCs can use several complementary or subsidiary channels to increase the fire power of their political activities.

How then to apply these models to Indonesia? How to address the few shortcomings which the review of the other models have revealed? We find the best and most relevant model in two articles by Gary Becker (also of Chicago).[67] Becker's articles build on the various schools of thought just mentioned (rent-seeking, Bentley, Olson, and the Chicago school of the theory of economic regulation).

THE CHOSEN MODEL

The plan of this section is to first describe the general framework of Becker's model, then to address the issues of group formation, cohesion, and objectives, and finally to assess the consequences, in terms of economic efficiency, of the activities of pressure groups.

General Framework

Becker presents a general equilibrium model of political pressure, with a description of the conditions leading to, or pushing away, from equilibrium. The premise of Becker's work is based on Bentley's views about the central role of pressure groups in political life.[68] Pressure groups engage in three activities:

(1) Attempts to reduce taxes paid
(2) Attempts to increase subsidies received
(3) Control of free-riding within the group.[69]

Becker offers a theory of competition among pressure groups that determines the equilibrium structure of taxes and subsidies for the whole society. In the model, all political favors are either a tax or a subsidy. A *subsidy is defined as any political activity that raises the income of the group*, including hidden subsidies like restrictions on entry into an industry or protective tariffs. A *tax is defined as any political*

[67]Becker (1983, 1985). The 1983 article presents the model without much discussion about the practical implications of Becker's findings. The 1985 article summarizes the key findings of the model and discusses its policy implications.

[68] In Becker's model, as in Bentley's, politicians, political parties, and voters receive "little attention because they are assumed mainly to transmit the pressure of active groups" (Becker 1983, p. 372).

[69] In our rent-seeking model so far, we have divided group activities in three categories as well: (1) the group's promotion of its interests (attempts to decrease taxation or increase subsidization), (2) the group's protection of its interests (attempts to limit taxation or to maintain subsidization), and (3) attempts to reduce free-riding. "Rent-seeking," therefore, covers influence related to both taxes and subsidies.

activity that reduces the income of the group, including hidden taxes like inflation or taxes on future generations.

To present his model, Becker uses a Ramsey-like analysis of the relative deadweight loss of taxes and subsidies, which allows him to derive key propositions about the quasi-market for political influence.[70] He starts with a simple budget identity for the government requiring that taxes equal subsidies. The budget identity means that there is no free lunch—subsidies must be financed by taxes. Since tax collection is not perfectly efficient, total taxes paid by taxpayers exceed the tax revenue of the state; and, hence, the amount of subsidies available. The wedge between taxes paid and taxes collected is called a deadweight cost (or loss). Similarly, the government is not perfectly efficient at handing out subsidies, nor is the recipient group perfectly efficient at distributing the subsidy. Hence, a dollar paid in subsidies becomes less than a dollar received in subsidies. The wedge between subsidies handed out and subsidies received is also called a deadweight cost. The larger the deadweight costs (i.e., the sum of the deadweight cost of tax and that of subsidies) associated with a policy proposal (e.g., regulation), the larger the loss to taxpayers compared to the gain to the beneficiaries of subsidies.

For example, with a 5 percent deadweight cost in tax collection and in subsidy distribution, if the government wanted a pressure group to receive $1 in subsidy, it would need to hand out $1.05. In turn, for the government to collect $1.05, the taxpayer would need to pay $1.1025. The greater the deadweight costs, the greater the incentives of taxpayers to seek to limit or reduce the amount of taxes they pay.

The differential impact of deadweight costs between taxpayers and recipients of subsidies (¢10.25 in our example) has important implications for the dynamics of the quasi-market for political influence. Indeed, the deadweight costs associated with taxes stimulate taxpayers to seek to reduce their tax burden, whereas the deadweight cost associated with receiving subsidies discourages recipients of subsidies to seek to influence policy to obtain further subsidies. Put it another way, the existence of deadweight costs of taxes and subsidies implies, respectively, that the monetary

[70]Ramsey (1927, pp. 47-61). Ramsey developed a theory of optimal taxation, where marginal deadweight costs are related to marginal "social worths." Becker, however, focuses on *actual* as opposed to *optimal* policy choices. (See Becker, 1985, p. 344.)

equivalent of a dollar reduction in taxes exceeds one dollar, whereas the monetary equivalent of a dollar increase in subsidies is less than a dollar.[71] As a result, taxpayers have an *intrinsic advantage* over recipients of subsidies.

Pressure groups seek to influence policymakers to obtain an optimal combination of taxes and subsidies. Due to the intrinsic advantage of taxpayers, no group would only receive subsidies or only pay taxes. Groups always pay some taxes and receive some subsidy. Indeed, the group's incentive to exert political pressure to decrease its tax burden tends to exceed its incentive to exert pressure to raise subsidies.[72]

It is the competition between pressure groups, conditioned by the intrinsic advantage of taxpayers, that leads to equilibrium in the political quasi-market of influence. Equilibrium is the situation where, through group activities, the structure of taxes and subsidies satisfies both taxpayers and recipients of subsidies. It is the competition among pressure groups which determines the price attached to a particular regulation. In this view, the government is merely a transmitter of the political activities of pressure groups.[73]

Although Becker does not refer explicitly to Coase, the workings of the quasi-market do look like an extended version of Coase's private bargaining between independent parties. As mentioned in the introduction, Coase's seminal paper on "The Problem of Social Cost" (1960), was the first paper to solidly link institutions, transaction costs, and neoclassical economics. In what came to be known as the Coase theorem, the private bargaining between two independent and self-interested parties in a dispute about the cost allocation of an externality (e.g., river pollution) will lead to an efficient outcome—i.e., an outcome by which market failures (like externalities) are

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[71]Since the marginal social costs of subsidies tend to rise as subsidies increase, while marginal social benefits of subsidies—as any other marginal social benefit—tend to fall, even without any pressure from taxpayers, subsidy recipients are discouraged from exerting additional pressure. Moreover, as Becker emphasized, increased levels of taxes and subsidies, by raising the marginal social cost of taxes, encourage taxpayers to exert additional pressure. This means that higher levels of taxes and subsidies tend to raise the "countervailing political power" of taxpayers. (Becker, 1985, p. 334.)

[72]See Becker's notion of "cross-hauling," whereby groups would specialize into pure taxpayers and other into pure recipients of subsidies. The intrinsic advantage of taxpayers makes such possibility unlikely. (Becker, 1985, pp. 334-335.)

[73] This transmission of political activities works as follows. Faced with a given policy problem, pressure groups have conflicting interests, which are transmitted to various government actors. Through a process of political arbitrage, the conflicting demands of pressure groups yield, in time, a consensus policy proposal that all groups agree on. The government then transforms the consensus into policy, and transmits it back as a regulation into the market.

internalized by the parties. This is done without any government intervention and the final outcome does not depend on the original allocation of property rights—provided the rights were clearly defined at the beginning of the process. For the efficient outcome to be attained, three conditions must be met: well defined property rights, zero transaction costs, and wealth effects can be ignored.[74]

To build his model, Becker shares Coase's insights about the efficiency of private bargaining between self-interested parties. Taxpayers and subsidy recipients negotiate the optimal allocation of taxes and subsidies. The outcome of their private bargaining will be efficient as long as the three conditions are met. Assuming that property rights are well defined (i.e., the rule of law applies in the collection of taxes and the distribution of subsidies) and that wealth transfers can be ignored, Becker's results hinge upon the size of transaction costs.[75] If transaction costs between taxpayers and subsidy recipients are trivial, then the outcome of their negotiations is efficient. In the limit, therefore, if organization and transaction costs are null, only efficient policies would be enacted since they are favored by pressure groups (whom all seek to decrease their tax burdens).[76]

Institutions like pressure groups are specifically designed to economize on transaction costs.[77] The best mechanism to generate a quasi-market with virtually no transaction cost is to have competition among pressure groups, as well as easy entry in the quasi-market. Indeed, the greater the number of participants and the more equal the access to the quasi-market, the more balanced their competition will be and the lower the aggregate level of taxes and subsidies. In other words, the more open the quasi-market, the more efficient the economy, because it will be freer from distortionary taxes and subsidies.

Conversely, if some pressure groups manage to monopolize the quasi-market, they will be able to obtain most of the subsidies the state hands out, at the expense of tax-

[74]Coase (1960, pp. 1-44). Actually, the Coase "theorem" is apocryphal. It is George Stigler who put Coase's insights into a "theorem" (Stigler, 1966, p. 13).

[75] We discuss below—in the section on the policy implications of Becker's model—the violation of the wealth transfer and the well-defined property rights assumptions.

[76]On this, see the discussion of Becker's model in Mitchell and Munger (1991, pp. 533-536 passim).

[77] Coase (1988, pp. 13-16) lamented about the over-emphasis by economists on the Coase theorem to the detriment of greater attention to positive transaction costs, which underscore the crucial role played by institutions in the economy. (Point made by Landa, 1994, p. 22.) See also Coase's article on "The Nature of the Firm" (1937) mentioned in the introduction.

payers. Also, the intrinsic advantage of taxpayers could be overcome by nonmarket actors who would deliberately support the monopolistic pressure groups at the expense of others. In the extreme, one pressure group could obtain all of the state's subsidies.

Two additional points are worthy of attention. First, Becker sees the policy process as one adopting the least inefficient alternative (and not the optimal one as in a pure Ramsey-like analysis). According to him, for each policy issue, there are hundreds if not thousands of possible regulatory arrangements. The chosen arrangement is the product of competition among pressure groups. Competition leads to an equilibrium at a point of minimal inefficiency, given the prevailing general structure of taxes and subsidies in the economy. The equilibrium is always temporary and the "logic of deadweight costs" leads the quasi-market toward more efficient outcomes (if the quasi-market is competitive).

Second, in Becker's model, *aggregate influence equals zero*. This means that the aggregate influence functions in terms of taxes and subsidies (found by adding all of the groups' influence functions) must be equal. Just as there is no free lunch in terms of government budget, there is no free lunch in terms of influence. In the aggregate, all influence related to the quest for subsidies must equal the amount of influence related to the quest for taxes in the quasi-market for political influence.[78] This also means that if the influence of a group suddenly increases or decreases, it will affect all the actors in the quasi-market.

Group Formation, Cohesion, and Objectives

Contrary to Olson, Gary Becker emphasizes the ease of group formation. Indeed, for Becker, groups form due to the attractiveness of the returns of rent-seeking. In line with Bentley's group theory, common interests among individuals lead them to form groups to increase their bargaining power and influence. In Becker's model, the common interest of pressure groups is represented by a production function (an "influence function") which depends on the number of group members relative to other groups and on the group's total political expenditures (i.e., cost of lobbying

[78]Therefore, Becker's model is essentially a zero-sum game in terms of aggregate influence, but a negative-sum-game in terms of taxes and subsidies because of deadweight costs. (See Becker, 1983, p. 377.)

activities). Each group has an influence function in terms of taxes and subsidies, which the group seeks to balance depending on other groups' influence functions. Presumably, everything else being equal, more group expenditure means more influence. And the larger share of the economy the group commands, the larger the resources it can bring to bear. But what about increases in membership (i.e., in the numerical size of the group)?

The relationship between group size and the production of influence is ambiguous, (despite a presumed tendency to be a negative relationship due to free-riding). Indeed, the total effect of a marginal increase in membership on the marginal product of political influence (i.e., the effect of one additional group member on the group's influence) is the sum of two terms. One is the measure of the returns to scale on political influence and the other is the amount of pressure exerted by an additional member. The former term can be positive or negative but, presumably, there is some increasing returns to scale on political influence—everything else being equal, a larger group has more influence than a smaller one. The latter term tends to be negative because of free-riding and gets more and more negative as group size increases.[79] According to Becker thus, free-riding tends to reduce the marginal product of influence. Because free-riding tends to grow as group size increases, it follows that as group size increases, the effectiveness of the group in producing political influence (the marginal product of influence) tends to decrease—or, put differently, the cost of producing political pressure tends to rise.[80]

As a result, like Olson, Becker sees free-riding as a powerful force reducing the effectiveness of the political influence of groups as they increase in size. Everything else equal, the effectiveness of group activities is reduced by the fact that, as membership increases, the group needs to devote increasing resources to combat free-riding. Becker, however, does not seek to directly model group cohesion as Olson does, since, like Bentley, he sees groups forming and maintaining their cohesion out of shared interests. Becker departs from Bentley in thinking that the effectiveness of

[79]Becker does not demonstrate mathematically that free-riding makes the marginal product of influence negative. He just recognizes the tendency of free-riding to make it so. Austen-Smith, in accordance with Olson, demonstrated that free-riding increases unambiguously with group size. Olson showed that the relationship between group size and political effectiveness is negative, while Austen-Smith showed it to be ambiguous.

[80] Again, these results are consistent with Olson and Austen-Smith work.

groups decreases as they grow in size, and he departs from Olson by not indicating that there is a point beyond which free-riding deters group formation and where groups remain latent. For Becker, their effectiveness may be blunted, but at long as there are positive returns to rent-seeking, groups will form.

In terms of group objectives, Becker shares Bentley's view that there is perfect identity of interests between individual and group objectives. The desire of individuals to reduce the taxes they pay and increase the subsidies they can receive is identical to the group's. There is no need for the group to resort to selective incentives to attract members. (Actually, there is no room for selective incentives since the only goods available in the quasi-market are taxes and subsidies.)

Table 2.4 summarizes the key elements of Becker's model in terms of group formation, cohesion, and objectives. The Table follows the same format as Tables 2.2 and 2.3 for ease of comparison.

Table 2.4

Key Group Attributes in Olson's and Becker's Models

	Olson's Model	Becker's Model
Group formation	Difficult (because of free-riding) Need political entrepreneur*	Easy (out of shared rent-seeking interests)
Group cohesion	Hard to maintain (because of free-riding) Need political entrepreneur*	Easy to maintain (as long as positive returns to rent-seeking)
Group objectives	Fundamental contradiction between individual and group objectives. Small groups can manage the contradiction, large groups must resort to granting selective incentives.	Identity between individual and group objectives. Free riding is recognized to be a problem diverting some of group's resources.
Group's political effectiveness as a function of its size	Decreases (because of free-riding)	Decreases (because of free-riding)
Effect of group political activities on overall efficiency	Negative and can lead to social paralysis and no-growth (Olson, 1992)	Positive if competitive quasi-market
Equilibrium in quasi-market for political influence?	No (quasi-market is not symmetrical)	Yes, given the general structure of taxes and subsidies

* Point made by Wagner (1966), Wilson (1974), and Moe (1980).

Pressure Groups and Efficiency

Probably the most striking proposition in Becker's model concerns the effect of the political activity of pressure groups on overall efficiency. Becker's model combines the insights of the Chicago school (about the theory of regulation) with price theory

to develop a general equilibrium model—which we refer to as a quasi-market for political influence.

Becker's initial assumption is the same as the proponents of the theory of economic regulation—namely, that "taxes, subsidies, regulations, and other political instruments are used to raise the welfare of more influential pressure groups."[81] Becker then extends Coase's theorem to pressure groups and shows that, regardless of government intervention, waste cannot be an equilibrium phenomenon. Using the logic of deadweight costs, Becker demonstrates that "selfish" pressure groups have an incentive to promote *efficient* policies—relative to the myriad of policies that never get enacted. Indeed, from an aggregate standpoint, the larger the deadweight cost of a policy proposal, the larger the loss of the "losers" compared with the gains of the "winners." Therefore, self-interested pressure groups have an incentive to promote policies that increase overall efficiency, even if this comes at the expense of narrower benefits (lower taxes or higher subsidies) for the group.

As a result, Becker concludes that the combined activities of self-interested pressure groups leads to efficient outcomes—i.e., policies that raise rather than diminish efficiency or output.[82] By so doing, he is able to solve the conundrum that we have underscored above—namely, that governments are observed to act for the defense and promotion of *both* the public interest and specialized interests (e.g., industries).[83]

This result counters the findings of the Chicago and Virginia schools who see government regulatory activities as inherently distortionary and, hence, inefficient. It is unique in the literature on economic pressure groups.[84] The result is particularly interesting since Becker starts with the same assumption as the proponents of the theory of economic regulation. The behavioral dynamics of the actors in the quasi-market of political influence allow Becker to reconcile reality with theory and to unify

[81] Becker (1983, pp. 373-374).

[82]In this way, Becker's theory provides a rationale for the deregulation drive of the 1980s in the United States—it is under the pressure of taxpayers (including or not the regulated industries themselves) that the government came to enact policies that were to the benefit of society as a whole (the common good), as opposed to that of the (de-)regulated industries.

83Because Becker uses the logic of deadweight costs to derive this result, he does not need to revert to notions such as social welfare functions or benevolent state to explicate why states can engage in seemingly contradictory activities.

[84] See Mitchell and Munger (pp. 532-533).

the two apparently contradictory activities of governments: to work for the common good (by producing public goods and correcting market failures) and to serve the interests of the more powerful (by taxing and subsidizing, hence reducing aggregate efficiency to the benefit of a few). Table 2.5 summarizes and compares Becker's insights with those of the Chicago and Virginia schools.

Given the positive impact of pressure group activities on overall efficiency, the condemnation of pressure groups' activities is excessive.[85] Rather than their activities or incentives per se, it is the pressure groups' unequal access to the quasi-market that leads to distortions and disequilirium. As such, democracies—characterized with more equal access to the quasi-market for political influence—are more efficient than authoritarian regimes—characterized by unequal access to the quasi-market by groups of unequal political influence.

Table 2.5

Rent-Seeking (Virginia and Chicago schools) vs. Becker

	Rent-Seeking (Virginia and Chicago schools)	Becker (Theory of competition among pressure groups)
Type of activity	Public, political activities	Public, political activities
Goal of activity	Generate rent through granting of preferential policy by government (Generate preferential regulation for Chicago school)	Obtain best combination of taxes and subsidies, given overall structure of economy
Impact on economic efficiency	Negative: rent-seeking always constitutes a diversion of scarce resources	Positive (i.e., increases efficiency) if competition in quasi-market for influence Negative otherwise
Intellectual forebears	Adam Smith (monopoly), Virginia school (Buchanan, Tullock, etc.), and Chicago school (Stigler, Posner, etc.)	Gary Becker

Originality and Relevance for CPC Analysis

There are three elements stemming from Becker's analysis which we find particularly original and relevant to our study. First, since the deus ex machina of the model is the logic of deadweight costs and their distribution among pressure groups

[85]See for example Olson's "Rise and Decline of Nations" (Olson, 1982), in which Olson argues that competition among pressure groups leads to social and political paralysis, and hence to a no-growth society. For a similar argument, see Olson and Landberg (1974).

(phenomena that take place regardless of the structure of government), it is applicable to nondemocratic systems as well. All other models presented in this study use the institutional background of advanced democratic economies of Europe and North America. Becker's model, in contrast, is directly applicable to emerging markets.

The second original element in Becker's model is the notion that the result of political pressure is a combination of taxes and subsidies, instead of only one of the two. All other models of pressure group activities reviewed here have a dichotomous outcome of "winners" and "losers." Probably the starkest application of this dichotomy can be found in the theory of the median voter, which argues that a policy proposal will be adopted if its proponents manage to convince voters, up to and including the median voter, that the policy is in their interests.[86] Implicitly, Olson, the Chicago School, and the Virginia School see the political process as geared toward picking "winners" and "losers." In the context of regulation, it seems much more realistic to have an outcome that is continuous.

The third original element stems from Becker's notion that aggregate influence equals zero. This means that the relative political influence of pressure groups changes continuously, depending on changes in the political effectiveness of other groups. If a group becomes more effective at obtaining preferential treatment, then the influence of all other groups is diminished proportionately. The parallel with Indonesia is striking. Suharto's kin entered in Indonesia's quasi-market in the mid-1980s. They changed the "rules of the game" of influence-seeking and perturbed a situation of relative equilibrium which Suharto and the Sino-Indonesians had built over two decades. In a decade, the kin came to virtually monopolize the quasi-market and sought to extort more and more "subsidies" from the system. By monopolizing access to the quasi-market, the kin essentially vitiated the competitive mechanisms of the quasi-market and, consequently, the structure of taxes and subsidies—generated by a monopolistic quasi-market—became highly inefficient. Such situation contributed to destroying the country's political and economic consensus and contributed, in our analysis, to Suharto's fall.

[86]See the median voter theorem explained, in its simplest form, in Enelow and Hinich (1984, pp. 8-14).

The relevance of Becker's model to CPC-based analysis can be illustrated with the application of the model to two important issues. One is to place the phenomena of deregulation and internationalization in Becker's framework. The other is to briefly discuss the role of the government, or nonmarket actors, in the model. In the context of a drive to a free market—with concomitant deregulation and internationalization—the budget identity implies that:

(1) Deregulation offers many more rent-seeking opportunities. Therefore, in a deregulating economy, we would expect to see more activity in the quasi-market for political influence than prior to deregulation.

(2) Internationalization offers the distinct opportunity for insiders to use their asymmetric information (knowledge of the domestic situation) and, at least in the short run, get more subsidies at the expense of foreign players who pay higher taxes relative to domestic actors.

Both phenomena, and the resulting rents available, are fueled by high economic growth. Both phenomena also explain the rent-seeking frenzy that has been observed over the last decade in Indonesia (see the case study, below). Since 1986, as the Indonesian economy was deregulated and progressively made more open to foreign investors, domestic CPCs had more and more opportunities to capture extra rents. It may seem paradoxical that a deregulating economy would generate more rents, since deregulation means more competitive markets which are characterized by no rent in a static perspective. In a dynamic perspective, however, it is true that in the long term deregulation means less rents, but in the short term, deregulation means more rents. Indeed, deregulation can essentially take two forms.

One is through privatization of state assets—including the transfer of various monopoly rights held by state entities to private markets. In most cases in emerging markets, there is limited capital formation, and capital is often concentrated within one or a few groups (CPCs in our framework). Essentially, privatization turns into the transfer of a public monopoly to private monopolies. Although there are reasons to think that, over time, private monopolies will crack under competitive forces more easily than public monopolies,[87] in the short run, privatization usually provides rents that CPCs will seek to capture. Another form of deregulation is the loosening of

[87]See on this the theory of contestable markets, as developed by William Baumol (Baumol, Panzar, and Willig, 1982).

cumbersome and extricate rules regulating economic activity—e.g., in banking or utilities. Because of the institutional immaturity of emerging markets, however, the lifting of restrictions usually means that complicated rules are replaced with a "wild West" situation with no rules at all.[88] The example of Indonesia's banking sector gone awry after the 1988 deregulation of the banking industry is such a case.

Whatever path deregulation takes, deregulation fundamentally means that rents are made available to private market actors. With high economic growth, existing rents become larger, and new rent opportunities develop. The existence of these rents, in turn, either attracts existing CPCs or leads to the formation of new ones. In the case of Indonesia, Sino-Indonesians took advantage of new rents, and Suharto's kin became an important new player in the quasi-market for political influence, in which they were essentially absent before 1986 (see the discussion on the Suharto and kin CPC, below).

With an economy booming at an average rate of 7 percent per annum and with multiple deregulation packages, the fact that no new actors could enter the market is a telling measure of the strong hold exerted by existing Sino-Indonesians and Suharto's kin on the quasi-market for political influence. Had the market been more open, one would have seen the entry of multiple new actors. With increased competition in the quasi-market, the equilibrium structure of taxes and subsidies would have been much more efficient. Instead, the quasi-market became more and more monopolized by existing domestic CPCs.

In their quest for rents, CPCs are limited by budgets that require subsidies to be financed by taxes. In an economy that opens up to international investment, foreign investors become a source of extra subsidies for domestic pressure groups. Indeed, domestic CPCs can use their asymmetric knowledge of the domestic conditions to extract a rent out of foreign firms who seek to obtain the "right" to enter the market. For a short time, therefore, foreign investors are subsidizing domestic rent-seekers; in Becker's model, foreigners pay taxes and domestic groups receive the subsidies.

[88]This phenomenon motivates organizations like the World Bank to help emerging markets build institutions, as local economies are being deregulated. See for example the Sector Adjustment Loan (SECAL) programs of the World Bank. For a description of these programs, see Samuel Paul (1990). For a general discussion of institution building, see Picciotto (1995).

Put differently, domestic groups can raise the returns to their political influence at the expense of foreign investors.

The motivations of foreign investors are rational. They accept to subsidize the local groups because (1) their expected returns on investment in the emerging market remain high enough, even net of the "subsidy" paid to local groups, and (2) they can transfer resources from one emerging market to another and pay the subsidy in one country from the proceeds of another (portfolio management). To a limited extent, it makes perfect economic sense for local actors to be paid for their knowledge of local conditions. The situation becomes untenable when the system turns into one of extortion.[89] Extortion, however, is unlikely to last as foreign investors discover the true cost of influence and realize that they are subsidizing local groups—i.e., they are paying taxes—without enough returns to their political expenditures. The intrinsic advantage of taxpayers, in time, leads foreign investors to actively seek to reduce their tax burdens and leave that particular market until conditions are more favorable.[90]

One major oversight in Becker's model is the government, or its actors. As already mentioned, Becker recognized that, in his model, politicians, political parties, and voters receive "little attention because they are assumed mainly to transmit the pressure of active groups."[91] In fact, although Becker does not directly address the issue, the more efficient the government is at transforming and transmitting pressure groups' demands, the more efficient the outcome in the quasi-market as well. (To recall, Becker assumes that the equilibrium level is solely a function of pressure group activities, the government is merely a pass-through institution.)

Becker does not describe the conditions under which the quasi-market could become so inefficient and captive of a few groups, that it would lead to more and more inefficient outcomes instead of efficient ones in "normal" times. Based on the model, we can infer that these conditions would probably stem, among other factors, from a violation of the assumption of Coase's theorem—i.e., well-defined property

[89] Olson's analogy with a monopolistic crime syndicate springs to mind in this instance.

[90] We show in the historical chapter that foreign merchants in medieval times used to withdraw trade from a trading center that did not protect them or provide them with an attractive business environment.

[91] Becker (1983, p. 372).

rights, trivial transaction costs, and possibility to ignore wealth transfers. In the case of emerging markets and of Indonesia in particular, these three assumptions are often violated quite dramatically. We have discussed before the crucial role played by pressure groups in reducing transaction costs. We address here violation of the two other assumptions.

The most important violation, in our mind, stems from the violation of the assumption regarding well-defined property rights. In a country like Suharto's Indonesia where the rule of law depended on ones connections to the first family, Coase's assumption that the property rights are well defined at the start of the bargaining process is quite often violated. In terms of the activities of pressure group, when a regulation can be overturned instantly by a presidential decree, the bargaining process supposed to take place in the quasi-market is severely undermined. Secondly, ignoring the effects of wealth transfers can also be an important violation of Coase's assumptions. When, as in Coase, the negotiation involves two private parties, ignoring wealth effects may be appropriate. But when the negotiation means the transfer of wealth on a grand scale—e.g., in the case of privatization—from the public sector to the private benefits of a few cronies, such wealth transfers cannot be ignored.

None of the theoretical models reviewed provides an adequate measure of the level of competition and free entry into the quasi-market of political influence. Specifically, we could not find good metrics that would help assess if and when a market is fundamentally unstable due to the lack of meaningful competition in the quasi-market. We suggest that case study analysis is the best way to assess such a question.

To sum up, we choose to rely on Becker's model for the following reasons:

- It does not depend on political structures; it is applicable to nondemocratic governments as well.
- It does not try to model the way in which political favors are traded; it only predicts the equilibrium structure of taxes and subsidies that will be derived from the activities of pressure groups.
- It suggests that competition among pressure groups leads to more efficient policy outcomes (than the alternative policies that would be selected without such competition). It recognizes, however, that if the quasi-

market for political influence is not competitive and is closed to entry, political activities by pressure groups will lead to the selection of less efficient policy outcomes.

- It allows for the explicit treatment of deregulation and internationalization, in the context of emerging markets, and can predict the initial outcome for foreign investors (i.e., not favorable) of competition for political influence.

CONCLUSIONS

The theoretical chapter has provided useful ways to think about the role and influence of CPCs in emerging markets. We have found it most useful analytically to place CPCs in a quasi-market for political influence on economic policy. By answering the three key behavioral questions of why, what, and how, we have been able to describe CPCs' incentives and activities. After reviewing a large swath of the existing literature on interest groups, we suggested that Gary Becker provided the most useful model of CPCs' activities in emerging markets, mainly because his model relies on the logic of deadweight costs and is independent of the role played by nonmarket actors—who are mere transmitters of the political influence brought to bear by pressure groups.

However, this lack of attention to the role played by nonmarket actors, although useful from an analytical standpoint, is unsatisfactory, as it leads to a failure of predicting the conditions under which the quasi-market would cease to function or would yield unsustainable outcomes. We suggest that the results derived form the historical analysis—and presented below—are more useful in this instance. These results suggest that, as markets develop, nonmarket institutions must develop as well. If they don't, the quasi-market becomes monopolized by a few existing groups. The groups that cannot enter the quasi-market, in time, will seek to develop alternative institutions to represent their interests (e.g., wrestle away authority from the king and confer it to Parliament instead).

In terms of the propositions that are guiding this research, the theoretical models presented provide an useful validation of the propositions. The findings of the Chicago and Virginia schools and Gary Becker confirm Proposition 2:

> The activities and policy influence of CPCs tend to grow as market capitalism develops. However, this growth may not be monotonic. As the number of CPCs increases, the result of their mutually countervailing effects may diminish their net influence.

In the case of Proposition 3, there is a sharp contrast between the proponents of the Chicago and Virginia schools, on the one hand, and Becker (and, to a lesser extent, Bentley and Olson), on the other. To recall, Proposition 3 states that:

> The influence CPCs exert on policy can be (and sometimes has been) beneficial and healthy, and sometimes perverse and counterproductive.

The Chicago and Virginia schools would argue that the influence of CPCs is almost always perverse and counterproductive. Becker, however, has developed a model which shows that, by and large, the influence of CPCs on policymaking is actually beneficial and healthy, as it leads to the selection of less inefficient policies. Becker recognized, however, that the foregoing outcome depends on the level of competition in, and ease of entry into the quasi-market for political influence. If the quasi-market is not competitive and is closed to entry, then it will yield relatively inefficient policies. As we shall see below, in the case of Indonesia, lack of competition in the quasi-market led to a virtual paralysis of all economic activity because of the opposition of CPCs to the IMF reform measures, as these were directly undercutting CPCs' power and sources of revenue.

We now turn to the empirical part of this study, beginning with a chapter relying on historical empiricism, before applying the framework to Indonesia.

COMMERCIAL POWER CENTERS IN HISTORICAL PERSPECTIVE

INTRODUCTION

Our historical excursion takes us first to the Middle Ages (eleventh to fourteen century) where we examine a situation of one CPC (the merchant guild) facing one decisionmaker (the local ruler) in a very primitive institutional setting. We then turn to the mercantile era and examine wool trade regulation in the context of two constitutional crises (conflicts between Crown and Parliament in the late-thirteenth to mid-fourteenth centuries). The wool trade example illustrates a situation of two CPCs (wool growers and wool merchants) facing two decisionmakers (King and Parliament). Both market and nonmarket institutions are more developed than in the early eleventh century. We conclude the section by examining two policies Elizabeth I (second half of sixteenth century) tried to implement. Both failed policies highlight the effects of increased competition among, on the one hand, market actors (many competing CPCs) and, on the other, nonmarket actors (Crown, Parliament, and judiciary). The section highlights the role of the judiciary in the evolution—and ultimate demise—of the mercantile economic system. Table 3.1 summarizes the three situations.

Table 3.1

Historical Examples

	Middle Ages	Wool Trade	Elizabeth I
Period	11th-14th century	Late 13th-mid 14th century	Second half 16th century
Situation	One CPC (merchant guild)	Two CPCs (wool growers and wool merchants)	Many CPCs (urban and sub-urban merchants & craftsmen)
	One decisionmaker (local ruler)	Two competing decision-makers (King & Parliament)	Many decisonmakers (Queen, Parliament, Judiciary)
Institutional Setting	Primitive	Developing	Toward maturity
Highlight	Role of guild	Role of Parliament	Role of Judiciary

MERCHANT GUILDS OF THE MEDIEVAL COMMERCIAL REVOLUTION

Between the eleventh and fourteenth centuries, after several centuries of economic decline, Europe experienced a period of extended economic growth—referred to as the Medieval Commercial Revolution. The period saw the growth of important trading centers across Europe, as well as the reemergence of trading routes across Europe and the Mediterranean. Medieval economies were natural, barter economies, organized around trading centers to which merchants would congregate and exchange goods. In the absence of a monetized economy, merchants of the medieval economy wanted to accumulate as many goods as possible. Medieval economic policy thus pursued a "policy of provision," whereby owning many goods provided merchants with more choices to strike good barter deals. Similarly, the larger the number of traders, the more the opportunities to barter. In the same line of thought, market participants shared the view that there was a fixed stock of goods that would be depleted by exports,[1] but which could be increased by imports.[2]

To encourage imports, though, local rulers must provide adequate protection to foreign (out-of-town) merchants and their property.[3] The protection of foreign merchants, however, was not the only challenge to trade expansion. Although trade can be initiated without any supporting institutions, it is not likely to expand without market and nonmarket mechanisms and institutions. The purpose of these mechanisms and institutions is to provide an *efficient* trading environment. Market mechanisms require information to be gathered and disseminated among market participants. Without such information, prices cannot adjust to their equilibrium position, and the market cannot develop. Nonmarket mechanisms require a set of adminis-

[1]Herbert Heaton reports about 200 English proclamations prohibiting or licensing exports during the thirteen and fourteenth centuries (Heaton, p. 381).

[2]In contrast, in a monetized economy (like that emerging during the mercantile era), in a barter economy, oversupply is the enemy since understocked markets allow for higher prices. Tight control of the number of suppliers is seen as the safest way to enforce cartel agreements among suppliers. In the mercantile era, trade promotion is the exact opposite of medieval trade promotion. Imports have to be severely restricted, since it is perceived that they would lead to the depletion of the quantity of bullion held in royal coffers and to the depression of local prices, whereas exports have to be encouraged, for they increase the revenues of the state, without depressing local prices.

[3]In 1283, commenting on Statutes supposed to level the playing field between local and foreign merchants, Edward I, king of England observed that: "Because ... there was no speedy law provided by which they [foreign merchants] could readily recover their debts ... many [foreign] merchants are put off from coming to this land with their merchandise to the detriment of merchants and the whole kingdom." *English Historical Documents*, Vol. III (1189-1327), edited by Harry Rothwell, p. 420. Cited in Moore (1985), p. 120.

trative and legal rules, which determine the rights and obligations of the trading partners, and insure adequate protection to the parties of the trading relationship.

At the beginning of the medieval commercial revolution, both market and nonmarket mechanisms and institutions were lacking. On the market side, merchants and traders were atomized; there was no mechanism to gather and disseminate information among them. On the nonmarket side, local governments of medieval English towns and cities were of minimal size and scope and did not provide the adequate institutional mechanisms required for trade to expand.

Despite these many market and nonmarket failures, the historical record is clear, trade did expand dramatically starting in the eleventh century.[4] Where did trade take place? How did it expand?

Guilds as Commercial Power Centers

This section examines the role and influence of merchant guilds in medieval Europe.[5] The guild was an administrative body that supervised the activities of local and foreign merchants. Merchants had more leverage on the ruler if they presented a unified front with coordinated demands. The objectives of the merchants, through the guild, were to obtain monopoly rights in their market and create a trading environment that attracted foreign merchants, with whom guild members wanted to trade. In short, guilds were established to address market and nonmarket failures in pursuit of the self-interested objectives of merchants.

We can think of the guild as a CPC facing one local ruler in the institutional setting of an economy in transition to a market-based economy and expanding greatly through trade. As a single unit, we liken a guild to a conglomerate in an emerging market. Both seek to address market and nonmarket failures in the pursuit of narrow self-interested economic interests. As a group, we liken the coordination activities among

[4]See Moore (1985) for a review.

[5]It must be stressed that we are talking about merchant guilds, which are not craft guilds. The former represent and defend the interests of all merchants, irrespective of which goods they are trading, while the latter are organizations of workers from the same craft—a much more focused definition of their common activity. For a detailed discussion of craft guilds, see Gustafsson (1987). His main thesis is that "craft guilds were founded primarily for guaranteeing a certain minimum of quality of the products produced by the craftsmen as a prerequesite for these getting a stable income and, likewise, a higher welfare for the community as a whole" (p. 13). Merchant guilds, in contrast, were established to defend the interests of merchants, not to guarantee quality.

guilds to the activities of CPCs in today's emerging markets. Both seek to enhance their economic interests and their influence over local rulers by coordinating their actions and presenting a unified front to the decisionmaker.

As mentioned above, medieval trade took place in trading centers (towns), which grew out of the success of trading fairs that were set up starting in the eleventh century. These trading fairs were owned by local rulers (lay and ecclesiastical landlords), who derived substantial income from market tolls. Depending on the institutional development of the trading center, to varying degrees, the organization of the fair was the purview of merchant guilds—and not of the rulers.

The attractiveness of fairs to merchants was their extra-territorial municipal nature. During and within the fair, against payment of a market toll, merchants essentially obtained a "blanket safe-conduct to trade and an entire framework of judicial, political, and economic defenses against possible abuse."[6] In other words, the local ruler and the merchants, organized in merchant guilds, entered a *quid pro quo* relationship, in which the ruler derived income (from market toll payment) and merchants obtained the right to trade and to administer the fair.

Given the barter nature of medieval trade, the key to the economic success of a fair depended on the numbers of merchants who congregated there. Local merchants thus faced a dilemma. On the one hand, they needed to attract out-of-town merchants and, on the other hand, they wanted to protect their own turf. In this environment, the objectives of the merchants were twofold: they sought monopoly trading rights in their hometown—to be granted by the local ruler—and, they sought to extract income from their trade with visiting merchants. To meet these objectives, merchants organized in guilds so as to present a unified front to the local ruler and extort from him these rights—which the ruler granted to obtain supplementary revenue.

One additional contextual factor explains medieval trade and the genesis of merchant guilds. Since the blanket safe-conduit extended by the local ruler to merchants was only offered during a fair, many merchants followed the fair cycle and went from fair to fair to do business—including to distant fairs in foreign lands. In

[6] Moore (1985, p. 102).

this process, itinerant ("foreign") merchants played a pivotal role. They could compare the level of amenities and protection offered by each fair, as well as evaluate the amount of business they could make. If they were not happy with the trading environment provided by a local fair, they would withdraw trade (i.e., decide not to trade there anymore) and go elsewhere (since there was fierce competition among fairs). These merchants were the spearhead of their locality or region and could provide valuable information, gathered and disseminated by their home guild, to their fellow merchants back home. Such information could lead to an informal or organized boycott of the fair by foreign merchants. The effectiveness of the boycott depended on the leadership role of the guild and how it could enforce the boycott among its members.[7]

The merchant guild was thus an administrative body that supervised the activities of local and foreign merchants to promote and protect the interests of its members. In its market function, the guild assumed the key function of information gathering and dissemination, not only for local merchants but also, through mutual recognition agreements among guilds, for merchants in other towns or lands. The better the guild performed its information gathering and dissemination functions, the better informed its members were, and the more leverage they had in deciding to boycott a trading fair if protection was inadequate.

In its nonmarket function, the guild defined and interpreted property rights, organized the rules of trade among merchants, and determined rules of dispute settlement. As markets developed, these nonmarket functions were taken over by the local government and the guild became more and more an institution confined to market activities, promoting and protecting the narrow economic interests of its members.

The analogy between the medieval situation and today's emerging markets is striking. The venue of the fair is the local (domestic) market. The guilds (today's CPCs)

[7]An early example of this enforcement mechanism is provided by this Flemish regulation of 1240 for trading in English fairs, which stipulates that: "If any man of Ypres or Douai shall go against those decisions [made by the guild] ... for the common good ... that man shall be excluded from selling, lodging, eating, or depositing his wool or cloth in ships with the rest of the merchants. ... And if anyone violates this ostracism, he shall be fined 5s, unless he can explain on oath that he did not know of the misdeed" (Moore, 1985, p. 298).

seek an economic environment conducive to business growth. As appropriate, they address and internalize market and nonmarket failures.

On the market side, the functions of guilds were similar to conglomerates in today's emerging markets. Horizontal integration was and remains an important mechanism to internalize market failures, especially with respect to information. On the nonmarket side, guilds offered their members the judicial and institutional setting necessary for trade to expand. In this function, guilds internalized nonmarket failures. Conglomerates in today's emerging markets also internalize nonmarket failures such as, among others, the lack of bankruptcy laws and efficient mechanisms of commercial dispute settlement.[8] Contemporary conglomerates also perform nonmarket functions, such as trade data gathering, in lieu of the state bureaucracy.[9]

To enhance their role in addressing and internalizing both market and nonmarket failures, guilds coordinated their actions and rulings with other guilds. Similarly, we suggest that in today's emerging markets, conglomerates coordinate their actions within CPCs to enhance the efficiency and influence of their actions. Guilds of the past and CPCs of today perform these functions in the pursuit of their narrow economic interests.

As a further analogy, the medieval foreign merchants were like today's international investors. They were wooed and cajoled by the local guilds (who needed trade to expand) and by the local ruler (who got supplementary income and power through increased trade). In both the medieval and the modern cases, guilds (CPCs) use their privileged knowledge of the local environment to extort economic benefits from foreign merchants. Yet, these merchants play a pivotal role in the development and success of the fair since they can decide not to trade there and go elsewhere if they feel that they are not striking a good bargain in the given trading fair. There were then, as there are now, enough trading centers for itinerant merchants (investors) to choose from.

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[8] Indeed, conglomerates decide themselves whether to discontinue a line of business or how to settle disputes between companies belonging to the conglomerates. As such, they perform nonmarket functions.

[9] In Indonesia, Apkindo, the trade association for plywood—under the control of Bob Hasan, a leading Sino-Indonesian tycoon—performed data gathering and publication functions. This was done, against payment by all plywood manufacturers, to keep a stronghold on the plywood market and enforce minimum prices. Under strong IMF pressure, the association was eventually dismantled.

Repeated-Game Model of Trade Expansion

We present in this section a theoretical model investigating the role played by guilds in trade expansion—through information gathering and dissemination, and coordination and leadership functions. The information function addresses the market failures with regard to information which characterize emerging markets. Coordination and leadership are important to assure the effectiveness of collective action. The relevance of these issues to today's emerging markets lies in the fact that, to promote and protect the interests of their members, CPCs also fulfill these information functions and coordination and leadership roles. How did guilds perform these functions and roles? What was the effect of these activities on overall efficiency?

In an interesting application of repeated-game models, Avner Greif, Paul Milgrom, and Barry Weingast (1994) set out to demonstrate in two steps that the merchant guild was the key facilitator of trade during the medieval commercial revolution. They base their findings on a set of four repeated-game models. These models depict in a simple and stylized way the actors' cost and behavioral functions in trade activities. These functions are entered in a Markov-chain model and repeated until they reach steady state (equilibrium) or, if equilibrium is not reached, after a large number of iterations.[10] The authors first show that trading relationships based on a *bilateral reputation mechanism* (guild playing no role) does not promote the *efficient level of trade*.[11] They then show that trading relationships based on a *multiple reputation mechanism* (guild playing a key role) does promote trade to the efficient level.

A bilateral reputation mechanism is a relationship in which a local ruler extends protection to the foreign trader. The motivation of the ruler stems from the current and future stream of pecuniary benefits that he derives from taxing foreign traders, as well as the growth of the town or city as a trading center, with various agglomeration benefits. The motivation of foreign traders is straightforward—they want a safe

[10]The key to the success of such modeling approach is the representativeness of the stylized situation. By carefully basing the models on the historical record, and by comparing results with this record, the authors provide a high level of confidence in their findings.

[11]Efficient level of trade is defined as the expected maximum total net value of trade, given the number of market participants, and net of the per unit cost of value traded incurred by each merchant and by the city for services rendered. In repeated-game models, the efficient level of trade corresponds to a Markov perfect equilibrium.

trading environment. If the person or property of the foreign merchant is not effectively protected, the merchant retaliates by not returning to the trading center. Under a multilateral mechanism, the ruler still agrees to extend his protection (and is lobbied, if not coerced, by the guild to do so). But in this scenario, the guild fulfills an information gathering and dissemination function that reports any case of violation to all of its members (locally and abroad). The guild may or may not have efficient enforcement mechanisms to force its members to comply with calls for boycott or trade withdrawal.

The results of the repeated-game models suggest that trade cannot be expanded to the efficient level by relying on a bilateral reputation mechanism. The chief reason is that the stream of future rents that can be extracted from the marginal merchant is close to zero—smaller than the value of goods that can be seized and smaller than the value of services that can be withheld.[12] A mechanism based solely on retaliation by the cheated party (the foreign trader) cannot lead to an efficient level of trade.

The same result is found under an *uncoordinated* multilateral reputation mechanism.[13] The reputation mechanism is uncoordinated inasmuch as it only relies on word-of-mouth communication. The guild does not perform any information gathering function. This is an important result since it highlights the fact that, even allowing for word-of-mouth communication, efficient trade cannot be reached without an efficient, centralized system of information gathering and communication. An institution is needed.

In the second step of their argument, Greif, Milgrom, and Weingast demonstrate that trade expansion to the efficient level is only possible under a *coordinated* multilateral reputation mechanism. The mechanism is coordinated inasmuch as the guild performs its information gathering and dissemination function. In the first version of this coordinated multilateral reputation mechanism (game 3), the guild informs all its members (as well as the concerned ruler) about any contract violation and announces the resulting boycott of the trading place. The members learn of the

[12] Greif, Milgrom, and Weingast (1994, game 1, pp. 764-766).

[13] Greif, Milgrom, and Weingast (1994, game 2, pp. 766-767).

boycott, but can choose not to comply. The guild does not seek to enforce the boycott.[14]

Reaching efficient trade in this situation is all the more interesting since it is reached without any enforcement mechanism. Finally (game 4), under a coordinated multilateral reputation mechanism with the guild enforcing compliance within the guild (i.e., the members must apply the boycott or face sanction), the same result as in game 3 applies—trade at the efficient level can be reached.[15]

According to the results of the games, guilds were the enabling institution for trade to expand. Without guilds, trade might have expanded, but not to the efficient level. Guilds permitted trade to expand if and when they fulfilled information gathering and dissemination functions and coordinated the actions of their members. Guilds did not require a formalized enforcement mechanism to promote or protect the interests of merchants—namely, trade expansion.

Conclusion

Both the historical record and the theoretical game offer useful analogies to the early transition of emerging market economies to a market economy, in particular with respect to the often-relied-upon export-led growth strategy, with protection of the domestic market. The foregoing two sections highlight three themes of importance:

- Congruence of interest between guilds and merchants
- Congruence of interest between rulers and guilds
- Market and nonmarket functions performed by guilds, enhancing overall efficiency.

Both the historical record and the repeated-game models suggest that guilds did permit trade to expand and, therefore, were successfully meeting the goals of their members. Consistent with Bentley's and Becker's assumptions, we observe thus

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14. Greif, Milgrom, and Weingast (1994, game 3, pp. 767-771). It must be stressed that the historical record shows that a guild without strict enforcement mechanism (as was the case of the German *Kontor*—the organizational unit of the *Hansa* that coordinated the activities of German merchants abroad) is less effective in obtaining fair and equal treatment for its merchants in foreign trading centers. (See example of the conflict in 1280 between the local *Kontor* and the city of Bruges, as reported in Greif, Milgrom, and Weingast, pp. 759-760.)

15. Greif, Milgrom, and Weingast (1994, game 4, p. 771).

congruence of interest between guilds and merchants. Although strict enforcement mechanisms by the guild to force merchants to comply to the guild's rules point to control of free-riding, there is no evidence to support Olson's views about a fundamental contradiction between individual and group objectives.

Self-interested, rent-seeking motives of merchants organized in guilds provides the cement of the relationship between local ruler and guild. This relationship led to the development of a quasi-market for political influence. We observed congruence of interest between rulers (who need revenue) and guild and merchants (who need an efficient trading environment) in developing a market economy. Market actors (guilds) are the pro-active members of the relationship, whereas the nonmarket actor (ruler) grants economic benefits in return for political and fiscal power.

Congruence of interests notwithstanding, merchant guilds extorted political rights from local rulers (e.g., right to organize, hold court or assemblies, etc.) in *quid pro quo* arrangements of mutual economic benefits (market toll against monopoly profits), or of economic against judicial and political benefits (revenue for the local ruler—if not the right to carry over large debts, against granting rights to guild members).

In terms of functions, merchant guilds are established to address multiple market and nonmarket failures. The main market failure addressed by guilds lies in imperfect information flows, which guilds address through the efficient provision of information to their members. The main nonmarket failures addressed by guilds are the lack of definition and interpretation of property rights, the poor organization of rules of trade, and the ill-defined rules of dispute settlement, all of which are progressively addressed by guilds.

From an economic standpoint, guilds promote efficient trade. In accordance with Becker's model, guilds' "selfish" activities promoted more efficient policy outcomes. From an institutional standpoint, guilds are made necessary by the very absence of market and nonmarket mechanisms and institutions. They organize the market and supplement the government where its performance falls short of providing an adequate business environment. Growing trade provided impetus for political integration and the development of increasingly sophisticated state institutions that,

in time, would replace merchant guilds in their regulatory and quasi-lawmaking function.

As an initial and tentative analogy with present-day emerging markets, the following three points ought to be made. First, like in medieval Europe, emerging markets suffer multiple market and nonmarket failures. Second, firms in emerging markets also seek to internalize market failures through horizontal integration. Instead of substituting for the state in the face of nonmarket failures, however, they seek to persuade the government to provide the required economic environment. This can be seen as a result of the higher degree of institutionalization of today's emerging markets relative to medieval towns and states.[16] Third, information seems as important today as during the commercial medieval revolution. The need to collect and disseminate information motivates both the organization of firms (then in guilds, today in conglomerates) and the collective action of firms (then within a network of guilds, today within a network of conglomerates, which we call CPC).

TOWARD A MERCANTILE SYSTEM

Mercantilism as an economic doctrine (extending from around 1500 through 1776, publication date of the *Wealth of Nations)* departs dramatically from the economic conceptions of the Middle Ages described above (policy of provision and the like). The main tenet of the mercantile doctrine lies in equating specie with wealth (quantity theory of money). Applied to international trade, this conception leads to encouraging exports and discouraging imports (specie-flow mechanism).[17]

Classical economists like David Hume or Adam Smith pointed to the fallacy of these doctrines. Money is not wealth—it is only a veil, and trade is a self-regulating mechanism—a deficit has to be balanced by a surplus. Ergo, according to Hume and Smith, mercantilism could not survive, since the fundamental mercantile economic tenets were wrong and self-defeating.

[16] Even though, as mentioned above, trade associations like Apkindo in Indonesia have performed nonmarket activities.

[17] We are solely concerned here with the evolution of economic policy. At the political level, the fundamental drive of the mercantile era was state-building. As such, kings and parliaments wrestled political and lawmaking rights away from local rulers. From a political standpoint alone therefore, the guild system was not sustainable, since it was built at the local level, with the local ruler as the political interlocutor.

Traditional historians of mercantilism argue that mercantile economic regulations and fiscal policies stemmed from the double requirement of specie accumulation and perennial trade surpluses.[18] More fundamentally, this double requirement was the requisite for state building and state power. In this view, "the quest for plenty must be subordinated to the quest for power."[19]

According to a rent-seeking interpretation of mercantilism, however, the causation is exactly reversed. The pursuit of perennial trade surpluses was not the cause, but the consequence and "by-product of the interplay of numerous self-interested parties who were seeking rents from monopolization in these early nation-states."[20] These self-interested parties were both market and nonmarket actors.

On the one hand, merchants and producers lobbied the Crown and Parliament to obtain privileges. They requested these privileges under the pretense of the promotion of the public good—since, by exporting, they participated in specie accumulation and, hence, helped increase state power. On the other hand, nonmarket actors tried to further their own quest for power by using and serving these commercial interests.

We use the example of the wool trade in England during the thirteenth-fourteenth centuries to highlight the role of these actors. Given the importance of wool in the English economy, it is both appropriate and useful to use wool trade as an example. It is appropriate because wool was the staple commodity for export and was one of the largest sources of royal revenue.[21] It is useful to examine England's wool trade because the evolution of the tax and subsidy structure of the wool trade provides a good illustration of mercantile policy in the making, from its medieval origins.[22]

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[18] See for example, Heckscher, *Mercantilism*, 1955. For a critical review, see Herbert Heaton, 1937.

[19] Heaton, 1937, p. 378. Heaton points out correctly that mercantilism had two parents: "If kings wished to make economic means serve political ends, individuals, groups, regions, and classes were equally willing to use political means to secure profitable economic ends" (Heaton, 1937, p. 386). In economics, these two parents are called supply and demand.

[20] Ekelund and Tollison (1981).

[21] At the turn of the thirteenth century (1297), the wool of England was valued at half the worth of the country's land and wool taxes amounted to twenty percent of the whole land (Power, 1942, p. 73). In 1421, customs revenues from wool represented 74 percent of all customs revenues (Lipson, 1921, p. 87). By all accounts, English wool was of the highest quality and was sought after by Flemish, French and Italian merchants.

[22] For an account of wool trade in the thirteenth-fourteenth centuries, see Power, 1942, Lecture IV, The Taxation of Wool, pp. 63-85. For a detailed account of wool trade in the fifteenth century, see Power, 1933.

Wool Trade Regulation and the Constitutional Crises of the Thirteenth and Fourteenth Centuries

As commercial markets expanded, the quasi-market for political influence on economic policy became more complex, with more actors on both the supply and demand sides of the quasi-market. On the demand side, with increasing trade specialization, some merchants started defending their particular interests, instead of being part of guilds with heterogeneous membership. Given the central role of wool in the medieval and mercantile English economy, it is not surprising that wool merchants were the first to independently pursue their specific interests. These interests, however, were not always congruent with those of other actors of the demand side of the quasi-market—e.g., wool producers. On the supply side, national institutions replaced local ones and assumed many of the nonmarket functions that the guilds had performed in the high Middle Ages. The King, however, was no longer the only supplier of economic policy. Parliament, representing the interest of the burgess and large producers, entered a struggle for influence with the Crown to determine who would set taxes and supply regulatory legislation.

The existence, schematically, of four players (producers and merchants vs. King and Parliament) makes for a much more complicated game of influence-seeking and for less predictable outcomes. Merchants and producers used different channels of influence and sought to influence different policymakers. In turn, the policymakers tried to strike mutually beneficial agreements with one or both groups.

Like in the case of medieval guilds, the analogy between the mercantile system and today's emerging markets is striking. The pursuit of perennial trade surpluses and the quest for import and local monopolies is the by-product of the interplay among the many actors of the quasi-market for political influence on economic policy. State actors seek to build a modern state, while increasing their own wealth, and market actors seek monopolies of all sorts, which they see as the most convenient way to increase their wealth and power. The pattern of relationships which the wool trade example highlights is most similar to the pattern of relationships characterizing the many monopolies awarded to Indonesian CPCs.

War was a major activity of European kings and required financing. English wool was a staple commodity and was highly praised by foreigners. It is therefore not surpris-

ing that English kings sought to meet their financing needs from the wool trade. Regardless of the method of taxation, the King needed the wool merchants' cooperation.[23] Indeed, there were two ways to raise the tax—either *in* wool or *on* wool. In the former case, wool producers had to pay a tax in kind to the King. To mobilize revenue from the wool, the King would raise loans on the security of wool. For this financial scheme to succeed, the King needed the cooperation of wool merchants in the buying and disposing of wool. In the latter case, that of a tax on wool, the King found it more expedient to raise the tax on merchants. They would accept a tax more readily than wool growers because they could transfer the incidence of the tax either backward onto wool growers or forward onto consumers.

The mechanism for a backward shift of the incidence of the tax was to obtain an export monopoly and keep wool growers out of direct contact with foreign consumers.[24] The ability of merchants to forward the incidence of the tax depended on how much demand for English wool there was (how inelastic the demand for wool was). The more the wool was in demand (the more inelastic the demand for wool was), the more easily merchants could transfer the incidence of the tax onto consumers—foreign for the most part.

The forum of discussion between the King and merchants was the "assembly of merchants," which the King would summon when he needed to raise an extra tax. The assembly was thus a hybrid organization comprising both market (merchants) and nonmarket (King) actors. The assembly was close to the Crown's and wool merchants' interests. Interestingly, the merchants did not have their own association. Their common interests drove their common demands. Their collective action was very informal.[25] On the other side of the wool trade divide were Parliament and wool growers. The growers (powerful lay and ecclesiastical magnates), as well as small merchants who were not wool merchants (i.e., the great majority of the

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[23]It is important to note the consensual aspect of the process. In the thirteenth-fourteenth centuries, the crown's power to coerce was limited. The king would summon the concerned parties when he wanted to raise a tax or change its structure and tried to gain their cooperation.

[24]As an early example of this pattern, the first specific export tax on wool was imposed in 1275 by Edward I. It was accepted by merchants in a *quid pro quo* agreement by which the king would re-open free trade with Flanders, a great consumer of English wool.

[25]The medieval assembly of merchants is very similar in structure to the "deliberation councils" in existence now in Singapore, Malaysia, Thailand, etc., all modeled after the councils attached to the Japanese Ministry of Trade and Industry. (See Campos and Root, 1996, pp. 78-99. More on this is the last chapter about policy implications.)

burgesses) were dissatisfied by the tax and sought to redress the situation through Parliament. In contrast to the assembly of merchants, Parliament was a dedicated nonmarket organization, seeking to carve a role for itself as the sole representative institution of society's interests—in particular those of its key constituency: the knights of the shire, wealthy lay and ecclesiastical magnates, and most of the burgesses—all of whom resented the profligacy and absolutism of the Crown. In short, the assembly of merchants disappeared because it was a hybrid organization with one single purpose (wool taxation), while Parliament successfully turned itself into a dedicated nonmarket institution "in which were safely corralled all interests."[26]

The balance of power turned in favor of Parliament once the King increased the tax on wool trade to finance the Hundred Years' War, which started in 1336. With the increased wool tax, not only were wool producers opposed to the King's regulation, but wool merchants as well. The situation was made worse by the fact that, in 1343, the King gave the exclusive power of buying wool bonds to a small consortium of large wool merchants. After this, "the estate of wool merchants was definitely split in two, and the majority of the body turned to parliament and in future acted with and through the commons."[27]

Parliament seized this opportunity to claim the right to regulate the wool trade—taking the responsibility away from the King's assembly of merchants. The original objective of Parliament and its key constituency, the wool growers, was to abolish the "maltote" (extra tax on wool). In 1350, Parliament obtained control over wool trade taxation and regulation. Parliament got control over the power to tax through a two-point compromise: First, the export tax on wool would not be abolished. The King could maintain the maltote to finance the war. Second, to please its own constituency, Parliament acquiesced to the wool exporters' on one issue: the institutionalization of a wool trade monopoly, the Company of the Staple. The company was essentially a cartel agreement, enforced by the state, through which the overwhelming majority of the wool trade had to take place. The merchants could now work with little fear of domestic competitive pressure. By the same token, the King and Parliament knew now where to go to finance their ambitions.

[26] Power (1942, p. 85).
[27] Power (1942, p. 84).

The fallout of the constitutional crisis was thus the following:

(1) Status quo for the King

(2) Parliament got control over power to tax and obtained subsidy for wool growers

(3) Wool growers obtained a subsidy, financed by consumers—disproportionately by foreign ones

(4) Wool merchants obtained a legal monopoly for their trade.

To keep the organized cartel in place, a strict import ban on wool was enforced.[28] The resolution of the constitutional crisis was thus a victory for all: both the King and Parliament could claim victory, as well as the wool traders, whose special interests were now enshrined in law. This victory came at the expense of consumers—who, absent from the political game, bore most of the incidence of the tax.

The wool trade episode illustrates quite appropriately the actions of various players in the quasi-market of political influence on economic policy. On the supply side, we see a century-long struggle by Parliament to obtain the right to issue tax and economic regulation. After a fifteen-year battle (1336-1350), the King (Edward III) managed to maintain his revenue by striking an historical compromise with Parliament. Merchants and producers alike obtained great economic benefits from the competition among nonmarket actors to supply economic policy.

To sum up, there are three salient conclusions to be drawn from the analogy between English wool trade and CPCs in modern emerging markets. First, as markets expand, there is specialization among market actors (e.g., wool growers and wool merchants). With differentiated interests, growers and merchants seek to promote their interest through different channels. In the case of medieval England, Parliament rose to the occasion by wrestling control over taxation and regulation away from the King and his assembly of merchants, and by successfully defending the interests of wool growers first, and wool merchants next.

[28]The fight against wool imports took some interesting turns. For example, throughout the seventeenth century, there were several Bills and Statutes encouraging the use of—English—wool in all occasions. In 1621, some MPs objected to such a law because "we shall not know our wives from our chambermaids." To solve the problem, a Statute was passed a few years later, enacting that the dead must be buried in woolen cloth. (See Lipson, 1921, pp. 94-95 for a few more examples.)

Second, subjected to various and conflicting demands by growers and merchants, one single ruler (like a monarch) finds it increasingly difficult to serve these various interests simultaneously. Some growers and/or merchants start seeking alternative avenues to see that their interests are taken into consideration in the policy process.

Third, and lastly, the wool trade analogy shows that one single institution can accommodate different and countervailing interests if it is set up specifically to *represent* varied interests. The example of the English Parliament imposing an export tax on merchants and granting a subsidy to growers is illustrative of the political horse trading that can be done within a single institution. Individuals whose interests are not represented, consumers in the case of the wool trade example, ultimately bear the financial burden of the rents granted to organized interests.

The common thread among the three conclusions is that, as market capitalism develops, a single ruler cannot meet the many conflicting demands of market actors. The wool trade example suggests that Parliament is the nonmarket institution best suited to be the power broker among varied market economic interests. Despite the King's support, the assembly of merchants faltered as an institution. This may be the result of the lack of representativeness of interests of the assembly and the fact that it worked only under the summons and close auspices of the King.

The assertiveness of the conclusions must, however, be tempered by the recognition that the English and continental European economies were reeling under a crisis of epic dimensions that started in 1314. For three years there was the worst possible weather, which destroyed crops and badly hurt the frail medieval economies. Inflation soared and could not be controlled. In England, Edward II was captured by rival fractions and was executed in an atrocious manner.[29] Such an environment may have greatly precipitated (1) the desire to compromise by Edward III (given the fate of his predecessor), and (2) the ascendancy of Parliament (as a result of a weakened King). The quasi-market for influence does not exist in a vacuum. Although some forces are conducive to change within the quasi-market, external shocks can precipitate major realignments of political influence.

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[29]David Hackett Fischer (1996, pp. 39-40).

As the case shows in greater detail, the institutional framework of President Suharto's regime is a network of powerless corporatist institutions devoid of real representativeness and power. Similarly, Parliament has a very limited role in the policymaking process. Yet, according to the Indonesian Constitution, Parliament is the highest authority in the land, responsible for the election of the President and Vice-President.[30] Whether the post-Suharto era in Indonesia will prompt the Indonesian Parliament to rise and seek to fulfill its constitutional and historical roles is a matter of conjecture, but the historical record suggests that, in time, it will.

Local and National Regulations under Elizabeth I

After the constitutional crises described above, as market capitalism developed, the number and diversity of market actors increased dramatically. This section reviews two separate attempts by Elizabeth I to maintain and promote a mercantile system of economic policy. Both attempts resulted in failure because of the increased competition among market actors and the enhanced role played by a third major nonmarket actor, the judiciary. Whereas the previous section seemed to be of immediate relevance to today's Indonesia, this section may be of relevance to other more developed emerging markets—e.g., South Korea or some Latin American countries—but not yet to Indonesia. Indeed, this section presents an environment with multiple competing market actors, a parliament with fairly well defined roles, and a judiciary coming to age and trying to define its role among nonmarket institutions. Such an environment does not yet exist in Indonesia.

Fragmentary regulation at the local level allowed some merchants and producers to escape the regulatory and legislative reach of urban (merchant and craft) guilds by moving to the suburbs. The guilds tried to stop this exodus by seeking to obtain from the Crown national regulations to unify codes and regulations and, it was thought, level the playing field among economic actors. The interests of the Crown were both financial (guilds were important taxpayers) and political (build national state power). Given the multiplicity of actors with divergent interests and the possibility to escape regulations, the old formula of organizing and enforcing cartels to impose market discipline, inherited by medieval guilds, was no longer appropriate. The efforts by

[30]Actually, this role is that of the higher assembly, the People's Consultative Assembly (MPR). For details about the role of Parliament in Indonesian policymaking, see MacIntyre, 1992, pp. 31-35.

the urban guilds and the Crown would prove useless, especially in the face of an ill-conceived enforcement mechanism of the unified regulations.

The pattern of competition among nonmarket actors to supply taxes, subsidies, and regulation shown in the case of the wool trade continued and intensified throughout the mercantile period. The rein of Elizabeth I (1558-1603) is traditionally seen as the height of the mercantile era. In fact, her rein coincides with the apex of mercantilism in England, punctuated by the slow demise of mercantilism after her death in 1603. Trying to emulate the French example, the Queen tried to consolidate the Crown's power in two ways: through the codification of local industrial regulations at the national level and through the granting of monopoly at the national level. We review the former approach in this section and turn to the latter in the following section.

Local regulations, which had been the purview of the—urban—guild bureaucracies since the Middle Ages, had become ineffectual by the end of the Tudor dynasty (Elizabeth I was the last Tudor monarch). In a slow process over the Tudor era, merchants and industrialists moved to the suburbs to escape urban taxes and regulations. This social mobility was facilitated by the more fragmentary nature of economic policy in England, which had not come under centralized control as in France.[31]

Decisions regarding local taxes and regulations were reached at the local level by town councils and guilds, dominated by powerful urban merchants. Yet, the reach of the town's regulatory legislation was strictly limited. A move to the suburbs meant freedom from the regulatory reach of town councils. In practical commercial terms, this meant that merchants and industrialists who moved to the suburbs were no longer part of the organized urban cartels. Improved communications, growth of the urban economy, and other technological factors all contributed to an increasing shift of economic activity outside the town's perimeter.

The increasing competition from the suburbs would, over time, constitute the death knell of the mercantile system at the domestic level. Adam Smith stressed the competitive pressure from the suburbs as follows: "If you would have your work tolerably

[31]By the 1290s, the French trading fairs had already come under the king's authority. This stemmed mostly from the more centralized ownership structure of French fairs.

executed, it must be done in the suburbs, where the workmen, having no exclusive privilege, have nothing but their character to depend upon, and you must smuggle it into town as well as you can."[32]

By the late Tudor period, the exodus to the suburbs had reached significant proportions and threatened the interests of urban merchants—whose business activities were organized into cartels. Urban merchants used their clout (providing revenues to the Crown) with the Queen to see their interests protected. In 1563, the Queen codified all local regulations within one document, the Statute of Artificers. Heckscher, one of the most respected historians of mercantilism, provides the following assessment of the significance of the Statute of Artificers:

> The laws [included in the statute] are very significant in so far as they indicate a sincere desire to call a halt to the exodus of industry from the towns and in general to prevent the formation of larger enterprises especially in rural areas. It is true that the resistance was weaker against those powerful urban 'merchants' who employed rural weavers; the law did not place such great obstacles in their way as it did in those cases where the urban masters had to be protected from extra-urban competition.[33]

This passage not only highlights the role played by towns and merchants in the process of national regulation, but also highlights the selective protection that they seek in the enforcement of regulation. When the merchants' interests are concerned, imports (from rural weavers) into town are acceptable, but imports are not acceptable if they create additional (extra-urban) competition. Enforcement is key to the success of regulations. How well did Elizabeth's enforcement mechanisms work?

From the perspective of enforcement and of the Crown, the statute was a failure. Indeed, the statute provided that Justices of the Peace were in charge of the local application of the national code. Two elements rendered this mechanism ineffectual. First, Justices of the Peace were poorly paid or not paid at all.[34] Second, they were themselves, for the most part, merchants performing judicial duties on a *pro bono* basis. These two factors expectedly led to a system of selective protection and uneven enforcement of the statute. Local interests—sometimes those of urban

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[32] Smith (1776, Book 1, Chapter 10, Part II, pp. 144-145).

[33] Heckscher (1955, Vol. 1, p. 239). Interestingly, despite this observation, Heckscher does not drive the point home and does not make explicit the link between merchants' interests and the Queen enacting the Statute.

[34] Here again, the situation is in sharp contrast with the French situation, where intendants —the French equivalent of JPs, were well paid and had considerable power.

merchants, sometimes those of “free” merchants of the suburbs—would be protected and the national statute would not be evenly and aptly enforced.

In the end, the erratic enforcement of the statute by Justices of the Peace contributed to the unraveling of the very cartels and monopolies they were supposed to perpetuate. By the end of the mercantile era, the vestiges of the medieval organization of economic life would be destroyed. In its place, market capitalism would take place with the Industrial Revolution.

In short, the first attempt of the Queen at consolidating her power in economic policy turned out to be a failure. Social mobility and the existence of ‘regulations-free’ suburbs provided ways to escape urban regulations codified in the statute. This social mobility led to the multiplication of actors with diverse interests. Furthermore, the ill-conceived enforcement mechanism of Justices of the Peace did not provide urban cartels with the protection they requested. The cartels were doomed to fail.

The ill-fated attempt by the Queen to impose national regulation highlights the role of the judiciary and the importance of competition among market actors. In the face of competing interests among multiple market actors, national regulation can only be implemented if the judiciary is sufficiently paid—to maintain its independence from the largesse of market actors—and is not required to enforce an institutional environment that is fundamentally at odds with economic and social realities. The emphasis by the World Bank and the IMF on “governance” in developing countries, including the development of an efficient court system, is in line with the results of this historical analogy.

National Monopolies under Elizabeth I

In a separate effort trying to emulate the French example, the Queen tried to consolidate the Crown's power through the granting of monopolies at the national level as a way to increase revenues. In many ways, granting monopolies was more efficient than taxation. First, taxation was still very inefficient. Second, and perhaps more importantly, at the margin, monopoly creation was a more reliable source of state revenues than taxation. Indeed, aspiring monopolists, competing for the privilege, would reveal the present value of a monopoly (i.e., by including and discounting the future stream of revenues from the monopoly right). Through the bidding process

for monopolies and other rents, the policymaker would know the underlying value of a monopoly and did not need to try to assign a value to the monopoly right.

The system, however, was critically dependent on the permanence and durability of monopolies. The aspiring monopolist would not assign a high present value to a monopoly if the probability of losing the right in the near future was high. The competition among court systems in England would lead to a situation in which the durability of monopolies was in doubt. Hence, the system of national monopoly would also prove ineffectual.

This economic reasoning of monopolies vs. taxes is pertinent to the case of today's Indonesia. The main difference between the mercantile era and today's concerns the vastly improved tax collection methods of the modern state. Although tax collection is not as efficient in Indonesia as it is in developed countries, it works reasonably well, at least in terms of collecting taxes from the largest taxpayers (corporate and individual). The main similarity between the historical example provided here and today's Indonesia lies in the value-revealing aspect of monopoly granting. The President can know the value of a project by evaluating a set of competing proposals for the project.

This value, however, is the present value of the future stream of income that the aspiring monopolists expect to derive from the monopoly rights. This value is thus highly dependent on the permanence and durability of the monopoly. The catastrophic effects of a sudden "lack of (international) investor confidence" in Indonesia—and in other emerging markets periodically hit by financial and economic crises—may therefore be interpreted as a direct consequence of the perception by international investors of a reduced time-horizon attached to various monopolies for which they compete as vigorously as domestic investors. This section highlights the crucial role played by the courts in providing permanence and durability to monopoly rights.

The Queen tried to increase the Crown's revenues through the granting of franchises and monopoly rights on key commodities like salt, gunpowder, and the like. Whereas the failure of applying unified regulations at the local level can be partly attributed to the ill-conceived Justice of the Peace system, the institutional cause of the failure of the national monopoly system in England can be attributed to the

mercantile judiciary, characterized by competing court systems. These different courts worked at cross purposes and severely reduced the attractiveness of monopolies to aspiring monopolists.

To simplify, there were two competing court systems in England—royal and common law courts. By 1550 already, there was similarity and convergence of interests between the latter and Parliament. Both the common law courts and the House of Commons were increasingly representative and composed of wealthy merchants from whom the Crown was trying to extract revenues.

One can interpret the competition between the two court systems as a competition between nonmarket actors seeking to obtain the right to enforce the monopoly rights granted by their respective ally—the Crown for the royal courts, Parliament for the common law courts. Fundamentally, royal courts only sanctioned monopolies granted by the Crown, while common law courts only sanctioned monopolies founded on custom or by Parliament. This situation constituted a bifurcation in the legal recognition of monopoly rights.

In such a context, aspiring monopolists needed to severely discount the stream of future monopoly profits, depending on the probability of seeing the monopoly rights rescinded. Due to the active competition among the two court systems, the probability of such discounting was quite high. Royal (monopoly) franchises were not durable, and the system of national monopolies that Elizabeth had envisioned never succeeded. She herself acknowledged the failure of the approach by recognizing in 1603, the year of her death, that a monopoly franchise on playing cards was against common law.[35]

As in the wool trade, there was convergence of interests between Parliament and its main constituency, the merchants. Both in the struggle over regulatory legislation and the granting of national monopoly rights, the Crown relied on instruments that were no longer appropriate to an expanding and ever freer economy in which a growing number of actors with divergent interests were placing competing demands on policymakers. Parliament and common law courts would increasingly become the institutional channels of influence of merchants and industrialists.

[35] See Ekelund and Tollison (1981, p. 62).

The death in 1603 of the last Tudor monarch signified the *de facto* end of English mercantilism. "In the context of expanding industries, the net benefit from open competition outweighed the net benefit from crown protection."[36] Vain attempts by the first two Stuarts (James I and Charles I) to maintain or even expand the mercantile system were terminated with the execution of Charles I in 1649.

This section has highlighted the role of the judiciary in providing enough confidence to aspiring monopolists about the durability of the monopoly right.[37] In today's Indonesia, it is not the courts, but the President who offers this sense of permanence. The economic and financial crisis that has plagued Indonesia since July 1997 can be interpreted, partly, as a loss of confidence in the durability of Suharto's regime (which turned out to be justified). The system of monopolies Suharto, his family, and most major economic players (including foreign companies) had put in place over the last three decades seemed at risk of being dismantled under international pressure and, therefore, the present value of rents was virtually null. In such circumstances, no investor would invest anything and the economy could not be jumpstarted, even with IMF support and monies.

Conclusion

From medieval guilds to national mercantile policies, our historical excursion has revealed a few interesting features of the evolution of the quasi-market for political influence on economic policy—which we have highlighted in the conclusion of each subsection. With respect to our Propositions, the historical record presented here vindicates Propositions 1-3.

First, *the development of CPCs is a typical and normal phenomenon associated with the development of a market capitalist system; it is not aberrant, exceptional, or surprising.* From the high Middle Ages to the mercantile era, we observed the growth and development of economic interest groups, seeking to influence economic policy. Guilds and wool merchants and growers, as well as urban or suburbs-based

[36] Baysinger, Ekelund, and Tollison (1980, p. 255).

[37] For a fuller discussion of the role of the judiciary in providing durability and permanence to laws and regulation, see Landed and Posner (1975, pp. 875-911 passim).

merchants and industrialists, were all economic groups that sought to influence economic policy to promote or protect their interests.

Second, *the activities and policy influence of CPCs tend to grow as market capitalism develops. However, this growth may not be monotonic. As the number of CPCs increases, the result of their mutually countervailing effects may diminish their net influence.* In the mercantile period, the example of wool merchants and growers underscores the interplay among countervailing interests. Perhaps even more clearly, the competition between suburban and urban merchants and industrialists has clearly contributed to the decrease in the leverage of urban merchants over the Queen.

Third, *the influence CPCs exert on policy can be (and sometimes has been) beneficial and healthy, and sometimes perverse and counterproductive.* The dual role of guilds in monopoly creation and trade expansion during the high Middle Ages is a clear-cut example of the relative nature of normative judgments about CPCs' activities. Although monopoly creation is efficiency-reducing and, as such, is negative, trade expansion constitutes a positive contribution of CPCs to their local economy. The evolution over time of guilds, from trade facilitators (in the Middle Ages) to free market inhibitors (in the mercantile era), highlights the danger of intertemporal normative observations.

Looking at today's emerging market and the role of CPCs in these markets, the historical overview suggests three important conclusions.

First, commercial interests (individuals or firms) try to address market and non-market failures. To promote and protect their commercial interests, these individuals or firms seek to access and influence policymakers. To both address market and nonmarket failures and to increase their leverage over policymakers, these individuals or firms elect to pursue their interest through collective action, which can be formal or informal. This conclusion is directly congruent with Becker's view of the crucial role played by pressure groups in addressing market failures and seeking to improve overall efficiency—by addressing nonmarket failures.

Second, as commercial markets develop, nonmarkets develop as well. As both types of markets develop, the dynamics and interactions between market and nonmarket actors become more complex, and a quasi-market for political influence on

economic policy develops. This lends support to our critique of Becker, who only saw nonmarket actors as transmitters of influence. Although he is right in terms of the function of nonmarket actors in the quasi-market, he underestimated the importance of their role in economic development.

Third, as markets and nonmarkets develop, it becomes increasingly difficult for a single ruler to supply all the nonmarket goods needed for the expansion of commercial activity. Commercial actors either substitute for this and perform nonmarket functions themselves or seek alternative nonmarket institutions that will promote and protect their interests. The competition among state actors to supply these nonmarket goods to commercial interests is protracted and, at times, violent.

Last but not least, with specific application to the case of Indonesia, three observations can be made.

First, concerning the monopoly vs. taxes debate, like the English Kings and Queen reviewed here, President Suharto clearly appreciated the value-revealing aspect of monopoly granting. The crisis, if not the meltdown, that threatens, and has already affected Indonesia in 1998 can be likened to the burst of a financial bubble. In asset markets, sometimes asset prices can go unchecked and soar to create a bubble because, for various reasons, there is a disjuncture between asset and real market prices. Since monopolies are one of the goods traded in the quasi-market for political influence, one can think of Indonesia in the 1990s as a country that has experienced a bubble in its quasi-market (1) because of the lack of checks on the sole supplier of monopolies and other rents, President Suharto himself, (2) because of the increasing gap between the development of market and nonmarket institutions and actors, and (3) because of the increasing monopolization of the quasi-market for influence by the Suharto family and, to a lesser extent, the Sino-Indonesian CPC. The burst of the bubble was sudden and, to many, unexpected, but historical analogies suggest that it was bound to happen.

Second, the guild and wool trade analogies may be the most appropriate for today's Indonesia since, in both cases, we have situations with few CPCs and one or two key policymakers. Yet, in certain respects, the competition among nonmarket actors in Indonesia has not yet even reached the level of institutional richness of early mercantile England. The Parliament is still an institutional figurehead, with less

power than the English Parliament at the beginning of the Hundred Year's War. We show in the following case study that Indonesia has an institution (KADIN, the Indonesian Chamber of Commerce and Industry) which is somewhat similar to the assembly of merchants of Edward III.[38] The English example, however, casts some doubt on the ability of this institution to effectively become the nonmarket institution of choice to broker the many conflicting demands from market actors.

Third, the examples from the rein of Elizabeth I, have highlighted the crucial role played by the courts in providing durability and permanence to the goods traded in the quasi-market for political influence. Indonesia is still a far cry from having a judiciary capable of providing such a function. The relatively recent emphasis by the IMF and the World Bank on institutional development and enhanced governance is on the mark.[39] If Indonesia wants to see her markets develop, she will need to develop her nonmarket as well.

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[38]A more informal organization than KADIN is the select group of—mostly Sino-Indonesian—tycoons who President Suharto has summoned a couple of times over the past decade to enjoin them to participate more, through charity, in the social development of Indonesia. See for example Suharto's summons of February 1990, enjoining the 31 largest conglomerates to aim at transferring 1 percent of their equity to cooperatives (Schwarz, 1994, pp. 98-101 passim).

[39]See the World Bank (1998) and IMF (1999) reports mentioned in the first chapter. More on this in the last chapter on policy implications.

Chapter Four

COMMERCIAL POWER CENTERS IN INDONESIA

METHODOLOGY

Although Becker's model—with the few differences in emphasis suggested in the presentation of his model—is the most appropriate to represent the role and influence of CPCs in emerging markets, the model remains a general equilibrium model, which is highly stylized and needs to be "brought back to earth" to be useful in interpreting the complex dynamics of CPCs and economic policymaking. To this end, we present hereafter a step-by-step methodology for analyzing and assessing the role of CPCs on economic policymaking.[1]

The methodology is comprised of six related steps: (1) Definition, (2) Collection (I), (3) Identification and Selection, (4) Collection (II), (5) Analysis, and (6) Assessment.

As mentioned earlier, commercial power centers are defined as: *any group, combination, or coalition of large aggregate size, that seek to influence the design and implementation of government economic policies to suit their diversified economic interests.*

CPCs operate on the demand side of a quasi-market for political influence on economic policy, in which the goods traded are taxes, subsidies, regulation, and other political instruments of economic policy. CPCs seek to protect or promote their economic interests by influencing this market. Although CPCs pursue economic interests, they need not be economic in character. For instance, the

[1]For a more complete presentation of the methodology, see Treverton, Levaux, and Wolf (1998, pp. 3-11 passim).

military is a CPC in several emerging markets even though economic interests are not the military's primary interests.[2]

After the definition of CPCs, the second step involves an initial effort to assemble information on both business and nonbusiness organizations that exemplify the activities of rent-seekers. Among the indicators that can be collected to determine the aggregate size of CPCs, we retain: indicators of scale (e.g., sales, profits, employment, assets, liabilities, exports, imports); ownership (public, private, mixed); economic sector (consumer goods, producer goods, services); technology level (high, medium, low, dual-use); etc. In addition, it is important to determine the numerical size of CPCs under consideration. This requires the aggregation of data for types of businesses that seem to share important characteristics.

The third step requires the identification and selection of CPCs which truly have political influence and are worthy of more detailed analysis and assessment. This step requires both explicit criteria to guide the selection process and critical judgment. Again, in the spirit of this study, we do not devote great energy to producing a definitive selection metrics which would precisely determine whether a group is a CPC or not. Because the metrics need to blend economic with social and political dimensions, the selection criteria are highly context-dependent and subject to change with little notice (especially in the case of an economic or political crisis). We suggest instead that the analyst, who is a country specialist, use judgment in the identification and selection of the "most important" CPCs in the country.

Correct identification of the boundaries of each CPC is particularly important. Indeed, if the CPC is defined too broadly (or narrowly), its inferred influence and/or policy interests may be biased upward (or downward). We chose in the case study to be conservative and only include the largest and most conspicuous members of each CPC.

Among the several dimensions noted above, the principal one should be scale—that is, the size of the selected CPC as measured by its sales, employment, assets, profits, etc. For nonbusiness organizations—such as labor unions or environmental groups—the relevant indicators might include membership, revenue from dues,

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[2] Such is the case in Turkey, see Lesser and Zanini (1998).

assets, etc. The relevance of economic size or scale as the primary criterion for selecting among candidate CPCs is that it is a reasonable proxy for current and/or potential "clout" in influencing public policies. Yet, the contrast in relative political influence of the Sino-Indonesian CPC compared to the Suharto family, suggests that scale may not be the only criterion of importance.

The second CPC criterion is proximity to the key decisionmakers. This proximity is best evaluated by a country expert and should be used to discount or augment the relative influence that one assigns to a particular CPC on a given policy.

More formally, we can look at the characteristics of CPCs under consideration to obtain greater breadth and diversity in the understanding of the activities they are involved into. For selecting and identifying CPCs, a more detailed list of criteria would include (the ranking is somewhat *ad hoc* and does not represent strict prioritization among criteria):

- *Scale*: What is the volume of sales, profits, employment, assets, and liabilities, and how have these changed over time? If it is not an economic unit, what other measures of its size are relevant?
- *Economic Sector:* What part of the economy? Does the center produce consumer or investment goods, services, or what?
- *Internal or External:* Does it engage in purely domestic activities, or does it import and export?
- *Ownership:* Is it privately owned, publicly owned, or mixed? Is it a foreign subsidiary?
- *Sources of revenue:* From which activity (e.g., export, import, domestic distribution) does the CPC derive most of its revenue? What is the share of revenue from government contracts, monopolies granted by the state, etc.?
- *Interaction with other CPCs:* Does the CPC enter into alliances, joint operations, etc., with other CPCs? If so, what does it bring to the table (e.g., political access, financing, technological or managerial expertise)?
- *Technology:* What *levels* and *types* of technology are embodied in the center's activities? And is the technology dual-use—that is, with fairly direct military application?
- *Region and/or Ethnic Identity*: In what region or ethnic community is the center rooted, and how important is this identity?

- *Institutional Lineage:* What is the provenance of the center—the military, state-owned enterprise (SOE), new entrepreneurs, and so on?

Once CPCs have been clearly identified and selected for analysis, more data collection is required (the fourth step) to increase the breadth and depth of the analysis of each CPC, and the interactions and relationships among them. Greater emphasis should be placed on collecting information on the channels of influence used by each CPC to access policymakers. This involves both recourse to additional data sources (e.g., interviews, more disaggregate data) and tracking of the CPCs' recent time trends with respect to each relevant criteria and policies of interest.

The fifth step is the analysis itself. It is likely, and indeed appropriate, that the analysis of CPCs in particular emerging market countries will exhibit some degree of diversity and noncomparability because of special circumstances prevailing in each country. Nevertheless, an effort should be made to assure ample commonality in the content of each country analysis. Without such commonality, comparisons across countries and among CPCs will be difficult, and the utility of the resulting product for policymakers and analysts will be diminished.

Toward this end, CPC analysis in each emerging market should highlight the following two key issues:

- Why and what CPCs do to influence policymakers?
- How they do it?

The determination of *why and what* CPCs seek to influence particular policies or policymakers stems from the need to identify the policy interests of the CPCs. This requires the determination of the specific policy domains on which each CPC focuses its political attention—e.g., tax policy, trade policy, opening or protection of domestic markets, national treatment for foreign investors or preferential treatment for indigenous investors. The second issue to define is *how* does each CPC access policymakers, which channels of influence it uses to influence policy and access policymakers.

In laying out the mapping of CPC interests and the channels of influence they use, attention should be paid to changes and continuities over time, as well as to the identification of potential vulnerabilities that could undermine the position and

influence of CPCs given current trends, or in the event of profound political or economic change.

Based on the foregoing steps, the final step should assess the effectiveness of each CPC's influence, or attempted influence, with respect to (a) specific policies that the CPC seeks to influence, and (b) the relative degree of influence exercised by other CPCs, which may be rivals. This assessment clearly underlines the key assumption we make between the objective interests of CPCs and the policies they seek to pursue.[3]

This assessment, however it may be formally approached, represents a conceptually challenging task. Besides the influence exercised by CPCs, many other factors—political, economic, external as well as internal conditions—affect policy formulation and implementation. Economic or political crises may dramatically alter the quasi-market for influence. Therefore, reaching conclusions about causation is quite problematic: If a CPC's preferred policies were to be adopted by a government, were the CPC's actions decisive or irrelevant, somewhere in between, or one element in a complicated set of policy drivers?[4]

In light of these challenges in assessing the influence of CPCs on policymaking in a given emerging market, it is important to be as explicit and critical as possible in trying to assess their role and effectiveness in bringing about a particular policy. As a hypothesis, CPC success in influencing the design of public policy might be thought to depend on four main factors:

- The degree of acceptance or resistance a policy receives from other centers, business, nonbusiness, and international organizations (e.g., IMF)
- The political power of the CPC (that is, the size of its social base and its power to mobilize political resources)

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[3] See the discussion about collective action in chapter 2.

[4] A positive answer to the direction of the causation between CPC actions and policies requires a detailed econometric analysis of the given policy and the mapping of CPCs' interests. For an example, see the paper by Carlos Ramirez (1998), who tried to determine whether the Clayton Act was enacted because of the pressure of concerned business groups to change the existing Sherman Antitrust Act. Ramirez gathered stock data of affected companies to determine which interest groups were affected by the legislation during its gestation period.

- The economic power of the CPC (that is, its importance as a contributor to growth and employment, including the linkages the center has established with other CPCs and with foreign business and financial sources)
- The type of linkages that the CPC has managed to establish with high-level government policymakers.

INTRODUCTION AND OVERVIEW OF ACTIVE CPCS IN INDONESIA

This section identifies, selects, and describes the major CPCs in Indonesia. The analysis was carried out prior to the onset of the economic, financial, and political crisis that has plagued Indonesia since July 1997. Although we have updated a large part of the information contained in this and the following chapters, these two chapters should both be viewed as an illustration of CPC analysis in the context of a period of rapid economic change—from 1986 through 1997. 1997-1998 constitutes the third, and last, major milestone in the history of Suharto's regime. The information and details about each CPC are likely to change quite dramatically over the coming few months (after May 1998), due to the fact that CPCs' activities are under close scrutiny in Indonesia and abroad and that the government is incapable of handing out any subsidy except for foodstuff, energy, and the like.

We limit the analysis and assessment to *four active CPCs* (Sino-Indonesian conglomerates, Suharto and family, SOEs, and foreign companies), a *hesitant CPC* (the military) and a *nascent CPC* (the *pribumi*—indigenous Indonesian—sector). For each, we provide data to describe the size and scope of the CPC, as well as some historical background to give some sense of change and continuity. We also provide an overview of the channels of influence each CPC uses to access and influence policymakers.

When President Suharto came to power in 1966 and started the new regime (New Order), Indonesia was one of the poorest countries in the world, with per capita GDP (in 1985 US$, based on purchasing power parity, PPP) of $612—similar to that of India, $653. Three decades later, in 1992, with an average GDP growth of almost 7 percent *p.a.*, per capita GDP (in 1985 US$, based on PPP) was $2,102—almost twice that of India's $1,282.[5] Similarly, life expectancy rose from 41 years in 1965 to 63

[5]Data from the Penn-World Tables, Mark 5.6, from NBER web site (http://nber.nber.org).

years in 1994. Suharto's Indonesia became a success story and, until the 1997-1998 Asian crisis, was used as a showcase of successful development.[6]

This success required active policy initiatives that inevitably frustrated some interests, but probably helped others. As former Economic Coordinating Minister Radius Prawiro once acknowledged: "[d]eregulation is an on-going process and you cannot do everything at once. To be frank, *we have to bargain with so many people, with so many producers, with so many manufacturers.*"[7]

We review Indonesia's CPCs in the following order: Sino-Indonesians, state-owned enterprises (SOEs), Suharto's kin, and the foreign sector. The order is consistent with a subjective ranking of the country's CPCs, and takes into consideration the size of the CPC, its ability to influence policy, and its vulnerability to policy changes.

Sino-Indonesian CPC

We rank the Sino-Indonesian conglomerates first because they hold by far the greatest raw economic power among the country's CPCs. We restrict the Sino-Indonesian CPC to the 200 largest conglomerates (see Table 4.1, below), with a small core group of 5 to 10 conglomerates with owners that are the political entrepreneurs of the CPC--i.e., provide the public goods (economy-wide system of monopolies, etc.) to the entire CPC. The top 200 largest Sino-Indonesian conglomerates command between 40 and 50 percent of the Indonesian economy and dominate the economy's fastest growing sectors. If the CPC is restricted to the top 9 conglomerates, their annual turnover sales still represents about 23.6 percent of GDP (see Table 4.2, below). However, this economic power is quite precarious, because of the high vulnerability of both Sino-Indonesians' position in Indonesia and their heavy reliance on personal channels of influence to ensure that their policy choices are adopted. Their power was thus highly dependent on the continuation of Suharto's New Order. It is too early to tell how Sino-Indonesians will be treated in Habibie's (or his successor) Indonesia. It is clear, however, that Indonesia could not return to

[6]American Embassy, Jakarta (1996), U.S. Department of Commerce (1997a), and Schwarz (1994, pp. 57-58).

[7]Financial Times interview, June 24, 1992, cited in Rodgers (1993, p. 16), emphasis added.

prosperity without Sino-Indonesians playing an important role in the economic recovery.

As Hal Hill reminds us, "it is impossible to overstate the sensitivity of the ethnic issue in Indonesia."[8] The riots of May 1998 and subsequent violence were largely targeted at stores owned by Sino-Indonesians. Sino-Indonesians have no natural constituency in government or in the bureaucracy to protect their interests. Support has to be purchased. The appointment of Bob Hasan as a member of the Seventh Indonesian Cabinet in March 1998 constituted a watershed and an anomaly, since it was the first time a Sino-Indonesian held a position in the Cabinet. The fact that Bob Hasan is not part of the first Habibie Cabinet confirms that his appointment was an anomaly that is not likely to be repeated soon.

Sino-Indonesians have used personal channels of influence and directly co-opt members of the palace or the military to see their interests protected.[9] These personal channels of influence had the advantage of being swift and flexible, but they also had the disadvantage of being highly dependent upon Suharto's regime. While SOEs have a long institutional history dating back to the colonial era, Sino-Indonesian conglomerates are mostly the product of the New Order. They were considered the beneficiaries of regulation in the 1970s (*i.e.*, protectionism and subsidized credits) and are considered today the beneficiaries of the deregulation and the opening of Indonesia since the mid-1980s. Although banking and financial deregulation has allowed them to grow in financial sophistication and relocate part of their assets overseas, their fate remains intertwined with the Indonesian economy.[10] As such, they will not disappear and will remain a powerful CPC in Indonesia.

State-Owned Enterprises CPC

We have ranked SOEs second because of their share of the economy and their ability to foster or block policies. There are a little less than 200 SOEs, each largely operating in their own "fiefdom." Some of the larger SOEs, like Pertamina (the state petroleum

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[8] Hill (1996, p. 106).

[9] This protection extends to personal safety. In the months leading to the general election of May 1997, several leading Sino-Indonesian tycoons had the military send soldiers to guard their homes.

[10] It was reported that the Salim group moved control of over $1 billion worth of equity in a core subsidiary, Indofood Sukses Makmur, to a Singapore-listed company in July 1997 (Shari and Barnathan, 1997).

monopoly) or PLN (the utility company), act as leaders of the SOEs' CPC by setting the terms of the government' support to SOEs. They have thrived for the past three decades (until 1997), thanks in large part to the protection they received from the military in the early years and from the technical ministries that oversaw them in later years. Under President Sukarno, Dutch properties, including mining operations and large plantations (of palm and rubber trees, clover, and many other tropical plants), were seized by labor unions and administered by military boards.[11]

Over the first decade of Suharto's New Order, the military sold many of the forestry and plantations concessions to private interests (mainly to Sino-Indonesians), and transferred control of the remaining SOEs (mainly resource-based operations such as tin production) to civilian public administration. After 1974 and with the oil revenue windfall from rising oil prices, large investment in state-owned capital-intensive enterprises were made by the Indonesian government. These SOEs came under supervision of various line ministries.

The record of these past three decades suggests that SOEs' vulnerability to changes in economic policy is quite low, but budgetary pressures and a greatly deregulated economy point to an uncertain future for them. One of the key decisions of the package of reform measures agreed upon between the Indonesian government and the IMF in October 1997 is the transfer of control of SOEs from the line ministries, back to the Ministry of Finance. This move undermines the channels of influence—i.e., the line ministries—that SOEs used to rely on to access policymakers. The influence of SOEs will be greatly reduced by this one action, but bureaucratic stonewalling will remain an important tool at the disposal of the line ministries and the SOEs they once supervised. Similarly, subsidies to some of the pet-companies of President Habibie (e.g., the aircraft manufacturer, IPTN) were curtailed under the second and third agreements with the IMF in January and April of 1998.

Although, SOEs in the manufacturing sector are retarding economic growth and development due to their low levels of efficiency and the large share of the economy they occupy, they are an essential part of the Indonesian economy. The political

[11]Indonesia is now he world's second largest producer of palm and rubber.

imperative of having a sizable sector of the economy not under the control of Sino-Indonesian conglomerates, requires a commanding state sector.[12]

Indeed, in the absence of sizable *pribumi* power (*pribumi* being indigenous Indonesians, *i.e.*, non-ethnic Chinese), the Indonesian policy elite wants to maintain a large state sector to help Indonesia's development without further concentration of wealth by Sino-Indonesian conglomerates.[13] The state is viewed as the bulwark against further expansion of Sino-Indonesian wealth. Yet SOEs' power is set to decline inexorably given the drain SOEs place on scarce government revenue, and the increased competition that they face from the private sector.

Suharto and Kin CPC

The third CPC is that of the Suharto family.[14] The gap in size and scope, if not influence, between the first two CPCs and the other two is immense. Although the family represents the second-fastest growing CPC (after Sino-Indonesians), the total revenue of Suharto-related businesses in 1995 represented a total of only 23.2 percent of the largest Sino-Indonesian conglomerate (Salim), or 2.3 percent of GDP. Given its unfettered access to President Suharto, the CPC has had tremendous influence relative to its small size. Suharto family members have often worked in close connection with Sino-Indonesian and/or foreign partners. With both types of partners, they would obtain financial compensation in exchange for their political connections with the President and their authority over the bureaucracy.

The post-1986 institutionalization of the family's activities and the public listing of its companies have contributed to a somewhat decreased vulnerability of the CPC to political change. Indeed, the assets owned by these conglomerates are less easily seized than money placed in foreign banking accounts—*à la* Marcos. Yet, the CPC's

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[12]On this, see Hill (1996, p. 107).

[13]Maintenance of a sizable state sector is actually a constitutional requirement (Article 33). During the February-April standoff between President Suharto and the IMF, the President made several public pronouncements to the effect that the reforms that the IMF sought to impose (e.g., privatization) were contrary to he constitution.

[14]During Suharto's rein, a case could be made that Suharto and kin CPC was the second, if not first, most important CPC in terms of political influence. Yet, we chose to rank SOEs before Suharto kin because, as subsequent events demonstrated, SOEs long-term influence and power is not nearly as vulnerable to political change as that of either Sino-Indonesians or Suharto kin. Despite the vulnerability of Sino-Indonesians, their commanding economic power outweighs their political vulnerability. The Sino-Indonesian CPC is likely to remain the most powerful CPC in the post-Suharto era.

obvious close connection to the presidential palace (and its reliance on "special deals" to further its business interests) remains an important liability due to the popular resentment its wealth generates. Moreover, Suharto family members have kept a large majority of their assets in Indonesia. It is not surprising, therefore, that they were so eager to establish a currency board to stem the slide of the Rupiah. The recent crisis in Indonesia has highlighted these vulnerabilities.

Foreign CPC

The final CPC is the group of enterprises controlled by foreigners not in the oil and gas sector. We exclude the oil and gas sector because it is insulated from the rest of the economy and functions under very different rules of investment, ownership requirements, etc. The oil and gas sector could literally continue to function under a situation akin to Nigeria—i.e., with foreign companies extracting and exporting the oil without almost any contact with the domestic economy.

Foreign firms in the non-oil and gas sector, in contrast, are an integral part of the domestic Indonesian economy and, hence, have interests they seek to promote and protect, and policies they seek to influence. The economic power of the foreign CPC, however, is quite limited. Direct investment by foreign firms (henceforth, unless otherwise specified, in the non-oil and gas sector) was less than two percent of GDP through 1990-1995, while their share of gross capital formation was below four percent, but rising.[15] Due to the critical role of foreign investors in determining the confidence level in the economic and political system of emerging markets (a role akin to that of foreign merchants in medieval trade fairs) and their role in bringing much needed technological and managerial expertise, the political power of the foreign CPC is larger than its economic power would suggest.

Foreign firms rely on personal channels to influence policymaking. They often form joint-ventures with local partners to "facilitate" bureaucratic obstacles. Because the interests of this CPC are largely congruent with the policies advocated by large international organizations (*e.g.*, IMF, World Bank) or western governments (*e.g.*, U.S., Japan, or E.U.), its interests are well defended, especially in times of crisis, at the

[15] Hill (1996, Figure 5.4, p. 77).

highest levels of the Indonesian government. They remain, however, highly vulnerable to changes in the domestic Indonesian economy and polity.

Before providing a more detailed description of each CPC, however, a brief discussion of the military as a "hesitant" CPC is needed. The role of the military in Indonesia is crucial for evaluating power centers throughout the economy. We call the military a hesitant CPC because, until the crisis that started in 1997, the military was clearly taking a second-seat in economic matters. The crisis, with its ensuing instability, has resulted in a review of such attitude in some military circles. Some may ponder whether to take a more central role in the direction of economic development. Under no circumstance, however, do we envision the military back in the business of actively managing businesses or plantations, as they did in the first decade of the New Order.

THE MILITARY: A HESITANTCPC

ABRI (*Angkatan Bersenjata Republik Indonesia*, or the military) exerts a central role in the political and social management of Indonesia. It does so by relying on the principle of *dwifungsi* (dual function), whereby ABRI has the dual function of defending Indonesia and taking active part in the development and administration of Indonesia.[16] As of 1986, there were "literally hundreds of military-owned companies, although the bulk [were] very small-scale operations with limited capital investment and a doubtful profitability."[17] Most of these companies date back to the 1950s-1960s. They can be sub-divided into four groups:

- *Command-Integrated Enterprises:* focused on manufacturing military equipment, fully integrated into the command structure of the various services
- *Civic Mission-Oriented Enterprises:* non-profit, aimed at strengthening the bonds between the military and the rural population
- *Regional Military Enterprises:* set up by territorial commands to supplement chronically insufficient military budgets

[16]For a detailed overview of Dwifungsi ABRI, see Singh (1995). For example, p. 52, he cites an article from a 1960 Decree still applicable today: "The Indonesian Armed Forces and the State Police shall participate in the process of production without diminishing their respective main tasks." For a succinct overview, see Robison (1994, pp. 52-53).

[17]Robison (1986, p. 259). Robison offers the best overview of the history of military-owned SOEs.

- *Military PTs:* established not only to bridge the budgetary gap, but also to provide employment opportunities for demobilized forces (after the war of independence) and more recent retirees.[18]

Robison (1986, pp. 250-270) provides a brief but detailed survey of military-controlled SOEs. Two conclusions can be drawn from his overview. First, the military has been generally unsuccessful in its own business enterprises, but has successfully traded political protection and forestry concession rights for budgetary resources. The main beneficiaries of this *quid pro quo* relationship have been the Sino-Indonesians who supported President Suharto when he was still a field commander. Robison provides an excellent summary of this pattern of public-private relationships:

> Through the mechanism of the company and the joint venture, Chinese and international capital effectively operate as the financiers of the military in that they provide the capital and organizational resources to turn the HPH [hak pengusaha hutan—forestry exploitation rights], the license, the contract or whatever concession into profits and, ultimately, income for the military. [Therefore], military corporate ownership of capital also means that the military has a vested interest in a corporate environment in which the state plays a dominant role in determining access to the market, to resources, production and credit through a system of monopolies, concessions and direct state corporate control of strategic sectors in the economy.[19]

This pattern of relationships forged by the military has since been utilized by other groups with commercial interests, such as companies owned by President Suharto and his kin, often jointly with major Sino-Indonesian or foreign conglomerates.

Furthermore, the influence of military-owned enterprises in the 1960s and 1970s was instrumental in the development of today's corporate Indonesia. Long-term strong bonds between the military and Chinese businessmen (e.g., Bob Hasan and Liem Sioe Liong, the head of Salim, the largest conglomerate in Indonesia) were developed in this period.

The result of such partnerships has been the successful process of capital accumulation by groups that have done business with the military. Since the mid-1980s, the liberalization of the economy has provided the Suharto family and well-connected Sino-Indonesians with great opportunities to capture additional rents from the

[18]Classification borrowed from Rieffel and Wirjasaputra (1972).

[19] Robison (1986, p. 258).

transfer of military-owned assets or companies to Suharto family members or well-connected Sino-Indonesian tycoons. By so doing, Sino-Indonesians and Suharto family members have greatly accumulated private capital over the past decade.

Sempati, Indonesia's largest private airline—although grounded as a consequence of the 1997-1998 crisis—is a good illustration of this pattern of relationships. Ownership of the company was split between PT Tri Usaha Bhakti (TUB, a holding company for the air force, with 25%); Mohammad (Bob) Hasan (Sino-Indonesian tycoon, with 20%); the Humpuss Group (controlled by Suharto's youngest son, Hutomo "Tommy" Mandala Putra, with 15%), and Asian Aviation Inc., a Malaysian-Indonesian joint venture partly owned by Hasan (with 40%).[20]

As for the influence of the military-owned enterprises today, it appears that "although the veto power of the military should not be underestimated, nor its coercive apparatus considered dispensable to the present government, its influence has clearly faded."[21] It is reported that every major SOE has former members of the military in its senior management. These retired officers, however, do not manage the companies on behalf of the military, but are working in a private capacity. They bring to the companies valuable contacts with, and some degree of protection from, the bureaucracy. However, except for anecdotal evidence, we found no reliable data to measure the participation of retired officers in SOEs (or private firms).

For the purpose of this study, we do not consider the military to be an active CPC with vested economic interests, but rather a hesitant CPC with general interest in a stable Indonesia. As such, the military may take an increased interest in the economic development of Indonesia. Depending on the pace of the country's economic recovery and/or the depth of its economic and social dislocation, the military may take a closer look at the structure of taxes and at the administration of justice to provide the bases for a once-again prosperous Indonesia in the future. The Indonesian military seems to agrees with Adam Smith that: "Little else is requisite to carry a state to the highest degree of opulence from the lowest barbarism, but peace,

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[20] Chotrani and Mecham (1996, p. 40). For more on TUB, see Robison (1986, pp. 261-262).

[21] Robison (1994, p. 50).

easy taxes, and tolerable administration of justice; all the rest being brought about by the natural course of things."[22]

SINO-INDONESIAN CPC

Description

Ethnic Chinese represent about four percent of the Indonesian population. We limit the Sino-Indonesian CPC to the largest conglomerates—i.e., the 200 conglomerates controlled by Sino-Indonesians, among the top 300 largest Indonesian conglomerates (see Table 4.1). These conglomerates have multiple links and cross-participation in each others' businesses and rely on informal communication networks to exchange information and strike business deals..[23] In addition to these large conglomerates, a multitude of successful small- and medium-size companies are owned by Sino-Indonesians. No aggregate information about their commercial activities is readily available. We have tried as much as possible to aggregate the Sino-Indonesian CPC net of these business activities.

The Sino-Indonesian CPC is relatively small numerically and can be viewed as a *privileged* pressure group, in which a few prominent members are able to deliver the public goods to the entire group. These prominent members are, among others, Liem and Bob Hasan. The economic size of their conglomerates is such that, "what is good for Indonesia is good for them." They have a vested interest in seeing the system of privileged monopolies and other subsidies awarded to them by the government kept in place. The precariousness of Sino-Indonesians in the Indonesian society constitutes a powerful mechanism to combat free-riding. When the going gets tough, all their members need to pitch in. Even if they can temporarily leave the country, their economic fortunes are intertwined with Indonesia's.

Among Sino-Indonesians, it is important to distinguish between *peranakan* and *totok*. The former have been established in Indonesia for several generations, and many do not speak Chinese anymore. Most of the conglomerates and the wealth of

[22] Smith (1776).

[23] For a graphical representation of the multiple links among Sino-Indonesian conglomerates, and with some non-Sino-Indonesian conglomerates, see *Overseas Chinese Business Networks in Asia* (1995, Table 3.1, pp. 43-44). On business relationships among Sino-Indonesian business tycoons, see Mackie (1992, pp. 177-182 passim).

the Sino-Indonesians, however, belong to the *totok*. The *totok* are first-generation Chinese who emigrated to Indonesia in the 1940s and 1950s. Some of them, like Liem Sioe Liong, started working with the military and Suharto early on. It is from these early links to the President that these businessmen obtained the concessions which later grew into business empires. Most of the Sino-Indonesian wealth is, both in perception and fact, a product of the New Order. Because of their late arrival to Indonesia, *totok* are still very well connected with the ethnic Chinese Diaspora in Southeast Asia and in Hong Kong.

The *peranakan*, for the most part still very wealthy by Indonesian standards, are not in contact with other ethnic Chinese groups. An example is the Gemala group, controlled by the Wanandi family, which is originally from Sumatra but whose younger generation were educated in the United States, Switzerland, etc. They do not speak Chinese. Similarly, the founder of the Astra group, William Soeryadjaya cannot speak Chinese and is a devout Catholic (like the Wanandis).

Ethnic Chinese took the lion's share of economic concessions available in the early years of the New Order—forestry concessions, import licenses, BULOG distributorship, and, most importantly, preferential state credit.[24] Eighty percent of state-bank credit had gone to Chinese businessmen by the end of 1972.[25]

Because of ethnic tension in Indonesia, no aggregate data on Sino-Indonesians' wealth are available.[26] Sino-Indonesians are routinely reported to control 70 percent of all private economic activity and fifty percent of GDP.[27] The Nomura Research Institute has estimated that ethnic Chinese control 73 percent of all listed equity.[28] If listed equity is representative of the manufacturing sector, then 70 percent of listed

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[24]BULOG (National Logistics Board) is a SOE in charge of stabilizing and controlling the price and supply of a few staple commodities. It allocates distributorship for these staple commodities. Typically, the allocation is done in a non-transparent manner and the beneficiaries are well-connected firms—*e.g.*, the Bogasoari Flour Mills, part of the Salim group. Most of the monopolies administered by BULOG are to be dismantled under the terms of the reform package signed with the IMF on April 8, 1998.

[25] Robison (1986, pp. 325-326).

[26]Details about the wealthiest Sino-Indonesian tycoons can be found in *Forbes* (July 15, 1996, p. 148). Of Indonesia's top personal tax payers, the Liem investors took four of the top six positions (Schwarz, "Empire of the Son," 1991, p. 47).

[27]Schwarz (1994, p. 99). Other telling measures of influence: according to a 1989 survey, 163 of Indonesia's top 200 business groups (not otherwise defined) were controlled by ethnic Chinese; more recently, in 1993, of the 162 firms listed on the Jakarta Stock Exchange, 80 percent were owned by ethnic Chinese (Schwarz, 1994, 109).

[28]See Wibisono (1995, p. 87), from *Asia Week*, 20 October 1993.

equity represents about 18 percent of GDP since manufacturing accounted for 25.5 percent of GDP in 1995. Furthermore, retail trade and hotels are almost totally dominated by ethnic Chinese, sectors which represent 16 percent of GDP.[29] Adding manufacturing to the retail trade and hotel sectors, Sino-Indonesian groups control over 40 percent of the Indonesian economy. Therefore, the generally advanced figure of 50 percent of GDP controlled by Sino-Indonesians seems reasonable. In 1988, the top 200 Sino-Indonesian conglomerates boasted an estimated total sales turnover of Rp 56,000 billion, or nearly twice the Rp 28,983 billion allocated for the 1989-90 state budget.[30]

Tables 4.1, 4.2 and 4.3 summarize the importance of ethnic Chinese business groups in the Indonesian economy. Table 4.1 shows that Sino-Indonesians control 80 percent of the assets of the top 300 conglomerates in Indonesia.

Table 4.2 lists the 10 largest business groups in Indonesia. Due to the difficulty of evaluating the precise size of sprawling conglomerates, there are as many rankings of conglomerates as there are publications trying to assess their size. For example, the Ndapura Group of Julius Tahiya (a *pribumi*) is ranked number nine in a tabulation by the *Economic and Business Review Indonesia,* but is ranked eleventh in our ranking (not shown on Table 4.2).

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[29]Sino-Indonesian conglomerates do not control all the large international hotel groups. For instance, the Ibnu Sutowo group controls the Hilton Hotel complex, and the Grand Hyatt is part of the Bimantara group. Nevertheless, Sino-Indonesians control most of the sector in Indonesia. This relative overstatement regarding the Sino-Indonesian control of the hotel business does not affect, however, the larger argument supporting the view that Sino-Indonesians probably control 50 percent of the Indonesian economy.

[30]Data from the U.S. Department of State (May 1996, p. 51). The data report Rp 70,000 billion for the top 300 conglomerates. Based on the data from Table 4.1 in the body of the document, we estimated that the Sino-Indonesian conglomerates control 80 percent of these assets.

Table 4.1

Ethnicity of Indonesia's Top 300 Conglomerates (As of 1993, by Gross Assets)

Ethnicity	Number			Total Assets (percent)		
	1988	1993	Change	1988	1993	Change
Sino-Indonesian	191	204	1.07%	74.6	80.1	1.07%
Pribumi	98	81	0.83%	23.4	16.4	0.70%
Joint Pribumi/Sino-Indonesian	11	15	1.36%	2.0	3.6	1.80%

Source: Adapted from *Overseas Chinese Business Networks in Asia* (1995, Table 3.2, p. 41), using data from Pusata Data Business Indonesia, *Conglomeration Indonesia*, 2nd ed., 1994.

By and large, however, differences among lists are limited to a few permutations in the ranking. The best we can say is that the data are very soft on this issue.

These caveats notwithstanding, Table 4.2 reveals both the dominance of conglomerates in Indonesia, and of Sino-Indonesian conglomerates in particular. The top ten groups represent 24.5 percent of GDP, with nine of them controlled by Sino-Indonesian concerns.

Only Bimantara (founded and controlled by Suharto's second son, Bambang Trihatmodjo) is non-Sino-Indonesian. Net of Bimantara, the revenue of the nine largest Sino-Indonesian conglomerates represents 23.6 percent of GDP.

Finally, Table 4.3 shows that Sino-Indonesian groups raise most of the capital on the Jakarta Stock Exchange (JSX). Prior to the 1997-1998economic crisis, they had raised the sophistication of their capital-raising methods with the use of bonds and involvement in exchange-rate and interest-rate swaps.[31]

Despite the lack of aggregate data, there is information on particular conglomerates or owners of these conglomerates. The best source to date was published three years ago by the Australian Department of Foreign Affairs and Trade (*Overseas Chinese Business Networks in Asia*, 1995). Yuri Sato's Ph.D. dissertation also offers a wealth of valuable information (summary translation in Sato, 1994). We will not repeat here the information about specific groups like the Salim or Sinar Mas groups.

[31] *Overseas Chinese Business Networks in Asia* (1995, p. 146).

Table 4.2

Indonesia's Top Ten Business Groups (1995 Estimates)

Rank (1995)	Group	Main Owners	Main Business Line	Estimated Revenues (US $ million)	Estimated Assets (US $ million)	Estimated Number of Companies	Estimated Number of Employees
1	Salim	Liem Sioe Liong family	Cement industry, Finance, Automotive, and Food	19,064	17,540	640	200,000
2	Astra	PT Delta Mustika, Nusamba and Public	Automotive, Agroindustry	7,062	6,766	342	51,000
3	Sinar Mas	Eka Tjipta Widjaja family	Agroindustry, Pulp & Paper, Finance	6,586	17,024	205	75,000
4	Lippo	Mochtar Riady family	Finance, Property	3,423	5,501	78	21,000
5	Gudang Garam	Rachman Halim family	Clove Cigarette	3,336	1,947	16	60,000
6	Bimantara	Bambang Trihatmodjo, Indra Rukmana	General Trade, Property, Chemical	1,679	1,186	54	11,000
7	Pasopati/Nusamba	Bob Hasan, Sigit Harjojudanto	Wood industry, Agroindustry	1,625	1,733	92	27,500
8	Gadjah Tunggal	Sjamsul Nursalim family	Tires, Property, Finance	1,516	8,091	81	31,000
9	Ongko	Kaharuddin Ongko	Finance, Property	1,500	3,010	59	8,500
10	Djarum	Robert Budi Hartono, Michel B hartono	Clove Cigarette	1,484	845	25	51,000
	Total Top 10 (By Revenues)			47,276	63,644	1,592	536,000
	As a Share of 1995 GDP			24.5%	33.0%		

Source: *Warta Ekonomi*, June 24, 1996 (http://www.indobiz.com/company/wartpublic.htm).

Note: All 10 groups, except Bimantara are Sino-Indonesian. Exchange rate is Rp/$ 2,308 and 1995 GDP at current prices is Rp 445,401 billion (EIU, 1996, pp. 75 and 90).

We have mentioned in the preceding two chapters that companies seek to integrate horizontally, in conglomerates, to address and internalize market failures, especially in terms of poor information flows and the poor reliability of price signals. Three factors make conglomerates vulnerable to market development and, as such, cast doubt on the future health of Sino-Indonesian conglomerates. First, these conglomerates have very complex structures. They have very little specialization and work across widely different business areas, from heavy industry to hotel management or textiles and apparel.

Table 4.3

The Ten Biggest Raisers of Capital on the Jakarta Stock Exchange
(As of August 1994)

Group	Number of Subsidiaries Listed	Total Funds Raised	
		Rp. billion	U.S. $ million
Gadjah Tunggal Group	6	1,867.68	848.95
Sinar Mas Group	4	1,157.22	526.01
Astra Group	4	1,502.26	682.85
Bakrie Group	4	1,446.23	657.38
Dharmala Group	9	1,131.80	514.45
Ometraco Group	6	999.73	454.42
Salim Group	5	932.57	423.90
Semen Cibinong	1	730.86	332.21
Lippo Group	7	659.49	299.77
Barito Group	1	659.49	299.77

Source: Adapted from *Overseas Chinese Business Networks in Asia* (1995, Table 7.1, p. 41) and from *Republika*, 'Peraup dana publik terbesar' (The biggest raisers of public funds), 10 August 1994.
Note: Rp/US $ exchange rate of 2,200.

They are often inter-linked through various partnerships and joint ventures with local or foreign partners. By and large, however, these links are not through cross shareholding.[32] Second, as these conglomerates grow, the Indonesian domestic market becomes too small for them, and they need to expand into foreign markets, starting in the ASEAN region. Hence, they develop an interest in furthering trade and

[32] *Overseas Chinese Business Networks* (1995, Figure 3.1, p. 43).

economic integration with other ASEAN countries. Third, as a result of the tendency of markets to correct market failures as they develop, the *raison d'être* of conglomerates as we know them today tends to disappear. Indeed, as markets improve, information flows and price signals usually improve as well—thus, there are less market failures to address.

If, as a result of the 1997-1998 crisis and the resulting change in government, the economy becomes less regulated, more open to the outside world, and less dominated by monopolies and cartels, then these three vulnerabilities will become more pronounced. Conglomerates will need to dramatically change the way they organize and do business if they want to survive. Many will disappear in the process.[33] First, in the absence of subsidized credits, the cheapest way to raise money will be through the domestic or international financial system. This will require a more open group structure and more disclosure. Second, in order to expand into ASEAN, the conglomerates will need to compete head-to-head with not only regional companies, but also large multinationals. This will be quite a challenge for conglomerates that have grown sheltered from meaningful competition. Third, as the economy becomes more deregulated, the very market failures that led to the creation of these conglomerates will disappear. To be successful, they will need to specialize and focus on their "core activities."

Assuming Indonesia implements the reform measures agreed upon with the IMF in October 1997 and January and April 1998, its economy will become a more open and more efficient economy over time. In such case, some important shakeout among conglomerates is probable, as well as the further consolidation of assets and concentration of activities by conglomerates.[34] The issue of anti-trust legislation and domestic competition is likely to become the next major policy battle in, and major

[33]If, on the other hand, the political crisis in Indonesia yields a repressive government returning to economic nationalism without access to foreign financing and capital markets, then the impact on all CPCs (not only Sino-Indonesians) would be devastating. Indonesia will look like Burma—a resource-based economy, with slower growth but, perhaps, more equitable growth.

[34]Over the past few years, there has been already a trend toward more specialization and restructuring of operations around core businesses (*e.g.*, Astra which vertically integrated its operations—from car assembly to distribution). Similarly, the restructuring of the banking system will yield more focused and specialized banking institutions.

challenge to, Indonesia's economic development.[35] If, however, Indonesia chooses to retrench, its economy will become more similar to that of Burma. In such an economy, conglomerates can survive, but not prosper.

Channels of Influence

Despite the symbiosis between the New Order and Sino-Indonesians, ethnic relations in Indonesia are still tense, as demonstrated by the acts of violence perpetrated against Sino-Indonesian shopkeepers during the riots of May 1998 and the sporadic episodes of ethnic violence since. Sino-Indonesian tycoons—owners of the large conglomerates which constitute this CPC—have purposely decided not to enter politics but rather focus their attention strictly on commercial matters. They choose personal channels of influence to advance their interests. Yet, this rule admits exceptions, and the future may be different from the past. In his study of the interplay between business and government in Indonesia, Andrew MacIntyre shows that in some cases Sino-Indonesians choose to keep a low profile and refuse to confront the government (in the case of the textile/spinning industry), while in other cases Sino-Indonesians can and do take a stand against the government (in the case of the pharmaceutical industry).[36] Yet these industry groups are much smaller than the conglomerates, and the occurrence of such collective action is still extremely limited. As mentioned above, we see the presence of a Sino-Indonesian, Bob Hasan, in the last Suharto Cabinet as an anomaly, not the beginning of a trend.

The only institutional platform representing the policy preferences of the Sino-Indonesian business community is the Centre for Strategic and International Studies

[35]Former ministerial advisor and Director for the Center for Agricultural Policy Studies in Jakarta, H.S. Dillon correctly pointed out that the reform of BULOG, under the IMF package of reform measures, is meaningless unless the government introduces anti-trust legislation. (McBeth, November 1997.)

[36]MacIntyre (1992). In the case of the textile/spinning industry, which is heavily controlled by Sino-Indonesians (Table 4.2, pp. 70-71), the Sino-Indonesians business owners clearly took the back seat and refused to take a stand. They agreed to follow a leading *pribumi* business owner (Husein Aminuddin) in his crusade against the government only because he demonstrated success in his bid to influence a governmental decision and because he chose a non-confrontational, very deferent attitude when dealing with the government (Chapter 4, pp. 66-141). In the case of the pharmaceutical industry, the leader of the "revolt" against the government was a Sino-Indonesian himself (Eddie Lembong), who, reportedly, constantly dismissed the notion that the "Chineseness" of the pharmaceutical would be a liability when negotiating with the government (see MacIntyre, 1992, p. 153). Of all the pharmaceutical companies in Indonesia, only one is *pribumi*-owned.

(CSIS) in Jakarta.[37] In the early 1970s, CSIS was one of the backers of the clique of bureaucrats who argued in favor of national economic development (with targeted protection of "key" sectors of the economy), while the bulk of its publications in the late 1980s and 1990s have argued in favor of a more open and deregulated economy.[38] In addition to CSIS, the Sino-Indonesian business community funds the Prasetiya Mulya Foundation, which was set up ostensibly to perform good social works and decrease ethnic tensions.[39]

In the absence of institutionalized channels of influence, Sino-Indonesians rely heavily on personal channels of influence, mostly with the military or the Suharto family. These channels have been reinforced through a system of co-optation whereby the Sino-Indonesian entrepreneurs offer various types of financial interest in their ventures to members of the Suharto family, the military, or other members of the Executive. Such methods are often referred to as *cukong*.[40]

These channels of influence have worked to the benefit of the Sino-Indonesian conglomerates thus far; however, they are vulnerable to a political environment without President Suharto's protection. This political reality reinforces the economic and business need to restructure these conglomerates into publicly traded companies that would, hopefully, be less vulnerable to political change.

The political crisis that is roiling Indonesia in 1998 may lead to a split among Sino-Indonesian business leaders with on one side, supporters of a regime of preferences and special deals essentially unchanged (e.g., Bob Hasan) and supporters of profound reforms that would allow them to expand in new markets (e.g., Eddie Lembong in the pharmaceutical industry) on the other. With the intense domestic and international scrutiny of monopolies and other special arrangements, the latter

[37]CSIS was established in 1971 by the Sino-Indonesian Wanandi family, in cooperation with leading military figures close to president Suharto, in particular Ali Murtopo and Sudjono Humardani (*Overseas Chinese Business Networks*, 1995, p. 46).

[38]On the support for the economic nationalists in the early 1970s, see summary of the writings of Jusuf Panglaykim in Robison (1986, pp. 148-151). On the later support for reform and deregulation, see among others, Pangestu and Habir (1989) and Pangestu (1994).

[39] *Overseas Chinese Business Networks* (1995, pp. 46-47).

[40]For examples of co-optation, see Robison (1986, pp. 301-308). The term *cukong* (or Ali-Baba system) was coined to describe the interaction between military-owned enterprises and ethnic Chinese; whereby an indigenous Indonesian (Ali) lends, against financial retribution, his/her name for a license to an ethnic Chinese (Baba, who could not obtain such a license due to his/her ethnicity).

group may have an opportunity to break the economic stronghold that the former had built over three decades.

STATE-OWNED ENTERPRISES CPC

Description

Research on state-owned enterprises (SOEs) is characterized by an acute lack of adequate data. No recent primary source data were available for this research.[41] The analysis relies on secondary sources and data current up to 1992-93.[42] In addition to data collection problems, SOE analysis is complicated by the complexity of determining which companies are publicly-owned and which are privately-owned. The distinction between the private and public sector hinges upon the definition of ownership—*e.g.*, privately owned, owned by the government, or owned by a foreign firm. Unfortunately, there are no recent data available in secondary sources on ownership. Ownership is a fuzzy, complicated concept, not readily amenable to classification in this instance. The tracking of firms, their subsidiaries, and joint ventures between government and other partners (private, domestic or foreign), is an exercise in investigative skills.[43]

By the end of the 'Old Order' of Sukarno (1965), the Indonesian government was the owner of about 800 companies in areas like agriculture (plantations), banking, trade, industry, and tourism. These SOEs were staffed with managers from the military or the civil service who had little or no managerial experience.[44] By 1965, the total number of SOEs was reduced to 233 through various reorganizations and consolidations. From the beginning of Suharto's New Order, the guiding principle of

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[41] An excellent primary source, in Indonesian, is the *Lampiran Pidato Kenegaraan*, published annually since 1983. This source has not been consulted for the purpose of this research (due to the linguistic barrier and availability problems).

[42] There is one excellent commercial database offering a very detailed review of SOEs: *Profile and Anatomy of State Owned Enterprises*, 4th ed., Jakarta, Indonesia: PDBI (Pusat Data Business Indonesia, Indonesian Business Data Center), 1997, as well as several other interesting reports about conglomerates, publicly listed enterprises, etc. Because of its prohibitive cost, however, this database was not consulted.

[43] The most recent data are used as much as possible. However, we chose in certain cases to use slightly older data in order to show the evolution over time of particular metrics, rather than a more recent point estimate. Therefore, we rely heavily on data from the 1994 World Bank report on Indonesia, which was very comprehensive. Many of these data have not been updated since 1994.

[44] Habir (1990, pp. 92-93). For an overview of the institutional history of SOEs, see also Pangestu and Habir (1989, pp. 225-227), Wibisono (1995, pp. 88-92), and Feith (1959, pp. 186, 206, 216-217, 230).

economic policy has been supervising rather than controlling economic activity.[45] The direct control of economic activity was indeed sharply decreased, and the number of nationalized enterprises were returned to their original owners (mostly Dutch, British and American concerns) in the early years of the New Order. In 1967, instead of being merely an appendage of ministries, SOEs were given more autonomy. They were restructured (Law 9, 1969) into three categories functionally divided along the axes of public service and level of financial support they could expect from the government budget:[46]

- *Perjan*—public service companies, like railway services, attached to a government department and financed out of the government budget. As of 1992, there were only two such SOEs
- *Perum*—commercial enterprises with a public utility function, such as telecommunications. There were 20 *Perums* in 1992, accounting for 11 percent of all SOEs (against 30 out of 189, or 16 percent in 1989), with ten in transportation
- *Persero*—profit-seeking limited liability companies (*Perseroan Terbatas*, PT). They are fully or partly owned by the Ministry of Finance. There were 160 *Perseros* in 1992, accounting for 87 percent of all SOEs (against 129 out of 189 or 68 percent in 1989).[47]

In addition to these three basic categories, several important SOEs have a separate and specific status. This remaining group can be further divided into three categories:[48]

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[45]Article 40 of the Resolution of the Provisional People's Consultative Assembly No. XXIII/1966, states that: "In implementing its role in the economy, the government has to emphasize more the supervision of the economy and, as much as possible, not the control of economic activity" (Habir, 1990, p. 93, citing Subianto).

[46]Data are from World Bank (1994, p. 140) and Simandjuntak (1988). Number and sectoral distribution of SOEs has remained remarkably stable throughout the 1980s. Since no major review of SOEs' organization has taken place since 1992, it is safe to assume that these 1992 figures are very close to 1997 figures. See also Hill (1987, p. 21) who mentions 214 SOEs in 1986/87, Nasution (1994, p. 134) who reports "some 190" SOEs in the late 1980s, early 1990s, and Wibisono (1995, p. 94) who mentions 180 firms in 1991/92. Unfortunately, Wibisono does not give a source for his data. He is, however, a business consultant and specialist on the question, having published extensively in both newspapers and magazines, as well as in academic journals. He stunned Jakarta in May 1987 when he claimed that in addition to the 214 officially listed SOEs (vs. 183 in Table 2.1, from World Bank data), the government ran or controlled an additional 206 enterprises. To this total of 420 SOEs should be added the plethora of *yayasans* and SOEs connected to the military (Hill, 1987, pp. 21-22).

[47]Details about SOEs' organization and restructuring can be found in, among others, Habir (1990, pp. 91-95); Pangestu and Habir (1989, p. 228); Mardjana (1995, p. 74); World Bank (1994, pp. 140-146); and Wibisono (1995, pp. 89-91).

[48]This classification into six categories (3 + 3) is borrowed from Rieffel and Wirjasaputra (1972, p. 104). Interestingly, more recent authors place the latter group of three types of SOEs into one heterogeneous group, with special emphasis on the large stand-alone groups. This may mean that the relative

- Large stand-alone SOEs governed by their own specific legislation—*e.g.*, Pertamina, the state petroleum monopoly; Garuda, the national carrier; state banks; and the commodity procurement agency, BULOG
- Local SOEs, owned and managed by provincial or local authorities. There is basically no information on them, except for the figure from the 1986 Economic Census figure of 122 SOEs operated by local governments[49]
- Military-controlled SOEs: four sub-categories (see prior section).

This report focuses on the so-called officially listed SOEs, which include the SOEs of the three first categories—except for their subsidiaries—and the large stand-alone SOEs. Because of the unavailability of data, we are not able to assess the importance of subsidiaries or of SOEs controlled by local governments.

The CPC composed of SOEs is a large, amorphous group with members whose common interests stem from their public ownership and close access to the bureaucracy. The political power of the group stems from its recognized importance in the country's development and in the large number of workers it employs. The common interest of the CPC is to perpetuate its importance in the economy and to maintain a large payroll, as a measure of its social influence.

Size, Scope and Performance of State-Owned Enterprises

Table 4.4 provides data on the share in manufacturing value added by ownership—government, foreign, or domestic Indonesian private. The data offer a broad view of the evolution of the role of SOEs in the Indonesian economy since 1975. Two points are worth emphasizing. First, in 1990 the decline in the share of manufacturing value added owned by SOEs represents a decline of only four percentage points from a 1987 peak of 26 percent. SOEs clearly retain a commanding position in the economy. This is even more true when oil and gas activities are included. SOEs own more than a third of the manufacturing sector. Second, the foreign sector's ownership share is essentially unchanged over the period and, to the detriment of SOEs, it is the domestic Indonesian private sector that is increasing its ownership share of the manufacturing sector, not the foreign sector.

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importance of local or military-owned SOEs has decreased, or that their evaluation is even harder than it was 25 years ago.

[49]Simandjuntak (1988, p. 227) citing the *Economic Census 1986*, Series B-31, Jakarta 1987, p. 17.

There are a little over more than 180 SOEs in which the government holds majority ownership. This number however excludes subsidiaries of SOEs and enterprises owned by local governments. Gross sales by the SOEs belonging to this 'official list', which also includes companies with special status like the oil monopoly, Pertamina, represent a little over 25 percent of GDP (see Table 4.5). Oil and gas related SOEs alone account for between 7.5 and 8 percent of GDP.

In terms of the distribution of SOEs, most are in industry (42 enterprises, 23 percent of total, mainly capital intensive), followed by agriculture (35 enterprises, 19 percent, mainly plantations), finance (30 enterprises, 16 percent, mainly banks), public works (19 enterprises, 10 percent), transportation (17, 9 percent), and ten other sectors (40 enterprises, 22 percent).[50]

Table 4.5 presents aggregate indicators of SOEs from 1979 through 1992, as well as annual average growth rates.[51] From 1987 through 1991, the number of officially listed SOEs remained stable at around 185 firms. Data from other sources mention a stable number of SOEs, between 180 and 200 from the mid 1980s through 1995.

In terms of size, data on assets and sales underline the large role of SOEs in the Indonesian economy. No data on exports by SOEs are available, underlining their strict domestic orientation in the non-oil and gas sector. No data on employment were available either, making an assessment of the SOEs' productivity impossible. In 1979, gross sales by state-owned enterprises accounted for 20.4 percent of GDP.

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[50]World Bank, 1994, pp. 140-141.

[51]Unless otherwise indicated, annual average growth rates are geometric growth rates.

Table 4.4

Manufacturing Value Added by Ownership
1975-1990 (percent of total)

	Excluding Oil and Gas			Including Oil and Gas		
	Govt	Foreign	Private	Govt	Foreign	Private
1975	27	21	50	35	19	45
1976	25	28	46	34	25	41
1977	26	29	46	34	26	41
1978	25	26	50	33	23	44
1979	26	25	48	39	21	40
1980	18	28	54	35	22	43
1981	19	28	53	36	22	42
1982	20	26	54	39	20	41
1983	22	24	55	39	19	43
1984	26	19	56	47	14	40
1985	25	18	57	46	13	41
1986	25	18	57	42	14	44
1987	26	18	57	40	15	46
1988	26	17	57	40	14	46
1989	24	19	56	38	16	46
1990	22	19	59	37	15	48

Source: Aswicahyono, et al. (1996, Table 4, p. 352).
Note: "Govt" refers to fully-owned enterprises and firms in which the government has majority equity holding. "Oil and Gas" refers to oil and gas processing (ISIC 353).

From Table 4.5, using 1986 as a dividing year between the prodigal oil-years and the current more frugal reform-years, one can see the relative decrease in importance of SOEs in the economy. Between 1979 and 1986, SOEs experienced a massive expansion. Total assets grew at an annual average rate of almost 25 percent; while sales grew from 20 to 30 percent of GDP, with an annual average rate of 6.9 percent for the 1979-1985 period.[52] With the bottoming of oil revenue in 1986, the government changed the course of policy. Faced with a fiscal crunch, the government decided to cut its equity investment in SOEs severely, slashing investment from Rp 412 billion in 1985 to Rp 86 billion in 1986 and Rp 57 billion in 1987.

[52] See also Bresnan (1993, p. 252-254).

Table 4.5

AGGREGATE INDICATORS OF STATE-OWNED ENTERPRISES
(Rp. billion, or percentage)

Year	Number of firms	Assets	Sales	Profit	Dividend	Rate of return	Sales as % of GDP	Gov't investment
1979		26,316	6,522	1,179	38.0	4.5	20.4	253
1980		34,514	9,796	1,422	69.6	4.1	21.6	477
1981		40,409	11,404	1,628	96.5	4.0	19.6	481
1982		48,268	14,533	1,329	153.5	2.8	23.3	337
1983		70,185	20,891	2,296	171.2	3.3	26.9	592
1984		87,368	25,920	2,200	266.0	2.5	28.8	336
1985		98,715	29,539	2,525	625.0	2.6	30.5	412
1986		118,966	28,269	1,811	583.7	1.5	27.5	86
1987	183	140,100	37,293	3,036	932.9	2.2	29.9	57
1988	187	124,013	40,065	5,170	636.4	4.2	28.2	125
1989	187	144,455	47,687	6,613	958.0	4.6	28.5	141
1990	186	179,153	60,990	8,300	1,096.0	4.6	31.2	323
1991	186	201,068	62,113	6,844	1,311.2	3.4	27.6	470
1992		231,232	68,446	6,290	1,053.2	2.7	26.2	150
1979-1985		24.7%	28.6%	13.5%	59.5%	-8.7%	6.9%	8.5%
1986-1992		11.7%	15.9%	23.1%	10.3%	10.3%	-0.8%	9.7%
1986-1989		6.7%	19.0%	54.0%	18.0%	45.3%	1.2%	17.9%
1990-1992		8.9%	3.9%	-8.8%	-1.3%	-16.3%	-5.7%	-22.6%

Source: Hal Hill (1996, Table 6.4, p. 102, using data from *Nota Keuangan* and Table 6.5, using data from *Lampiran Pidato Kenegaraan* and BPS, *National Accounts*) and World Bank (1994, Table 5.1, p. 141, using data from Ministry of Finance and Bank of Indonesia).

Note: Rate of return is pre-tax profit over total assets.

Between 1986 and 1992, all indicators show the growth of SOEs slowed, although with increased profitability (see below). Both asset and sales growth slowed down by about 13 percentage points for the 1986-1992 period compared to the 1979-1985 period, falling to 11.7 and 15.9 percent respectively.

An assessment of the profitability of SOEs is made difficult by the lack of transparency in financial results. The data, again from secondary sources, are consistent and point to poor profitability, especially for non-oil and gas related firms (see Table 4.6).[53] Rates of return never exceeded 5 percent, putting them below interest rates. Table 4.5 also shows the SOEs' profits increasing at a faster rate after 1986 (23.1 percent for 1986-1992 vs. 13.5 percent for 1979-1985)—suggesting that reform efforts called for by President Suharto in 1986 (see next chapter) had a positive effect on SOEs. Yet if we divide the period into two smaller periods, 1986-1989 and 1990-1992, the picture becomes cloudier. The important gains in profitability made from 1986 through 1990 slowed down in 1990-1992. The fiscal restraint of the latter half of the 1980s is also replaced by increased government equity investment in SOEs starting in 1990 and 1991, with an associated decrease in rates of return.

This trend toward more capital injection corresponds to the appointment of then Minister Habibie (now President) as head of the Coordinating Agency for Strategic Industries (BPIS), which is comprised of ten "strategic" SOEs. These are SOEs with large capital requirements, which are meant to spearhead Indonesia's high-tech development. Among these are aircraft manufacturer IPTN, steel producer Krakatau Steel, and shipbuilder PT PAL. The ten SOEs alone constitute half of all SOEs' losses.[54]

Although the Indonesian government had obtained, under the terms of the agreement with the IMF of October 1997, the right to continue subsidizing the loss-making companies of the BPIS, the second and third IMF agreements of January and April 1998 prohibited these subsidies. Without access to detailed accounting data, however, it is impossible to gauge the viability of these ten companies without government support—though it is likely to be precarious.

[53]Micro-level study of these enterprises also points to the poor performance of SOEs. See, for example, Hill (1996, pp. 104-105) and Mardjana (1992 and 1995).

[54] World Bank (1994, p. 142).

The evaluation of the SOEs' performance raises complex issues about the soundness of aggregating data across such a wide spectrum of firms and industries.[55]

Table 4.6

Financial Performance of Public Enterprises, 1987-91

	1987	1988	1989	1990	1991
All Public Enterprises					
Number of enterprises	183	187	187	186	186
Pre-tax-profit/total assets (%)	4.1	4.2	4.5	4.6	3.9
Pre-tax-profit/operating assets (%)	4.5	4.6	4.8	4.9	4.2
Pre-tax-profit/equity (%)	13.7	14.6	16.1	18.0	14.0
Pre-tax-profit/sales (%)	12.1	12.9	13.8	13.6	12.5
Number of lossmakers	43.0	35.0	28.0	21.0	24.0
Total losses/total assets (%)	0.5	0.2	0.1	0.1	0.1
Budgetary impact (% GDP)	(2.0)	(0.9)	(0.7)	0.5	(2.8)
Share of bank credit (%)	25.0	21.0	18.0	12.0	13.0
Share of state bank credit (%)	34.0	30.0	28.0	21.0	23.0
Excl. Banks and Pertamina					
Pre-tax-profit/total assets (%)	2.0	3.8	5.2	5.7	5.8
Pre-tax-profit/operating assets (%)	2.6	4.8	6.1	6.7	7.0
Pre-tax-profit/equity (%)	4.2	7.9	10.2	11.5	10.8
Pre-tax-profit/sales (%)	5.3	9.6	12.4	13.7	13.5
Total debt/total assets (%)	50.8	51.5	49.4	50.4	47.1

Sources Ministry of Finance and Bank of Indonesia, in World Bank (1994, p. 141).[56]

Table 4.6 offers a more detailed view of the SOEs' performance. The figures support the view of successful reform from 1987 through 1991. The lower part of Table 4.6 shows rates of return for SOEs excluding both the oil and gas and the state banking sectors. The non-oil sector has been performing better than the oil and gas or the state banking sectors. Indicators of financial performance demonstrate that these two sectors have experienced financial results even more dismal than those of other SOEs. It is not possible to determine decisively which of the two sectors (oil or banking) contributes most to this poor performance.

Channels of Influence

Although equity in SOEs is held by the Ministry of Finance today, this equity was controlled by technical or line ministries—e.g., the Ministry of Public Transportation

[55] For a review of these issues, see Pangestu and Habir (1989), or Simandjuntak (1988).

[56] "All SOEs" includes all SOEs with majority ownership by central government and excludes subsidiaries and local government enterprises. Fiscal impact is calculated as difference between sum of profit transfers and debt service to government, and government participation, subsidies and other disbursements. Tax receipts from SOEs are excluded since the same payments would be made if they were private enterprises.

overseeing public transportation SOEs, etc.—until November 1997. State-owned enterprises provided extra budgetary resources and influence to the line ministries. SOEs used these line ministries as main channels of influence to access policymakers. The payment for influence was—and remains—the provision of perquisites and fees for board participation that exceed the base salaries of civil servants. In addition, SOEs provide clout to their ruling ministers—who view SOEs under their control as agents of development within their sphere of activity and consider these SOEs as fiefdoms closed to public scrutiny. Such views are best exemplified, in the 1970s, with the management of Pertamina by Ibnu Sutowo and, in the 1990s, with the ten strategic enterprises under the direct control of then Minister Habibie.

One of the key measures in the package of reform measures agreed upon between the Indonesian government and the IMF in October 1997 is the transfer of the control of SOEs from the line ministries to the Ministry of Finance, which should greatly reduce the influence of SOEs. Nonetheless, bureaucratic stonewalling will remain an important tool at the disposal of the line ministries and the SOEs they used to supervise. The record of the past three decades supports the view of a bureaucracy that is difficult to rein in.

In addition to the budgetary and other financial resources they provide to their oversight agencies, SOEs derive much of their influence from their place in *Pancasila*—the ideology of Suharto's New Order (and, presumably, that of Habibie's). Inspired by socialist ideas and a deep mistrust of capitalism, the Indonesian Constitution and *Pancasila* assign a central role of economic development to the state sector. The clash between ideology and fiscal realities is nowhere clearer than in the case of privatization. As pointed out by Hal Hill, "in the late 1980s Indonesia was at the forefront of reform in trade, tax and finance policy. But it was a conspicuous exception to the worldwide trend towards privatization."[57] This exception may disappear as the Indonesian government tries to cope with the fiscal crunch brought about by 1997-1998 financial crisis by seeking to generate revenue through the sale of state assets. The main problem, however, will be to find buyers in an economy in which, for the moment, all investors have lost confidence in.

[57] Hill (1996, p. 101).

A supplementary source of the SOEs' political power stems from the fact that they also constitute an important vehicle for achieving the economic emancipation of *pribumi* business in Indonesia. To a large extent, privatization cannot be achieved politically, for the potential buyers would be—for manufacturing assets—Sino-Indonesians or members of the Suharto family, and—for plantations and resource-based assets—foreign firms. The largest foreign companies operating in Indonesia are heavily concentrated in the oil and gas sector, the mineral and resource-based sector, and plantations. For example in terms of revenue, after Caltex in oil (U.S.$ 932 million in 1995), the largest American firm in Indonesia (third overall, after Toyota Astra Motor) is Freeport, the mining giant (U.S.$ 741 million in 1995). The ninth largest foreign company is a Belgian company, Socfin Indonesia, controlling large plantations (U.S.$ 419 million in 1995).[58] Freeport and Socfin would probably be eager to purchase reasonably prices state assets, once the political situation is clarified.

But the three categories of potential buyers of state assets remain largely unacceptable politically, as their increased share of the economy fuels greater resentment among the Indonesian people and among domestic CPCs trying to keep foreign companies out of the most lucrative deals. Privatization experiences in transition economies (East and Central Europe, and Mongolia) suggests that various approaches to this process can take place. Some are revenue-generating, while others—such as those based on a voucher system—are not. A more original and diverse privatization process could help create more *pribumi* owners and managers.[59]

Although more recent data would be welcome to help us clearly assess the dynamics of the role and influence of SOEs in the economy, it seems important to draw lessons from the available data. First, at 3 percent of GDP, the fiscal burden of SOEs is quite substantial—although progress has been made since 1984 when the fiscal impact of SOEs represented 6 percent of GDP.[60]

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[58] See Widjaja and Yip (1998, Table 10.3, p. 226).

[59] See Cheryl W. Gray (1996, pp. 8-29) for a review of privatization approaches in transition economies.

[60] World Bank (1994, p. 142).

Second, the relative size of SOEs in the economy is declining. This decline can be inferred from three trends. One, the private sector holds an increasing share of bank credit, while the share held by SOEs is diminishing. If all loans to individuals are excluded, the SOE share of total remaining bank loans fell significantly, from 7.1 percent in 1990 down to only 4.3 percent in 1995.[61] If one uses the share of bank credit as a proxy for relative economic size or strength, the private sector's importance is growing, while that of SOEs is declining.[62] Two, the trend is also apparent within the banking and financial sectors. Perhaps partly due to the reform of these sectors, the share of GDP for these sectors has increased from 4 percent in 1988 to 10.8 percent in 1995. Here also, the lion's share of this increase is to be attributed to the private sector. The share of total deposits in state banks has decreased steadily from 64.6 percent of all deposits in 1986 to 45.8 percent in 1992, while the share of total deposits in private banks has increased from 23.1 to 44.5 percent over the same period.[63] Three, except in the oil and gas sector, SOEs are generally focused on the domestic market, while the faster-growing export market is dominated by the private sector. Therefore, the share of SOEs in the economy is bound to decrease continuously over time.

The third important lesson to learn from the existing data about SOEs is that the oil and gas sector's contribution to public finances has decreased tremendously. In terms of contributions to government revenue, oil represented about 70 percent of all government revenue throughout the latter half of the 1970s and first half of the 1980s. This share of government revenue from oil sales fell sharply to less than 30 percent at the turn of the 1990s and represents now only 16 percent of government revenue.[64] With worldwide oil prices very low (U.S.$ 12-13 per barrel) and likely to remain so for the foreseeable future, oil exports may not provide the Indonesian government with enough revenue to jumpstart the economy. This task will have to be accomplished by the private sector.

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[61] McLeod (1996, p. 79).

[62] In the shakeup of the banking sector taking place in 1998, state banks are not faring much better than private banks. Out of the 40 banks that have been placed under the supervision of IBRA, the Indonesian Banking Restructuring Agency, 14 are state-owned (three of the largest state banks and 11 state-owned regional development banks). IBRA was established in 1998 to deal with the restructuring of the Indonesian banking system. (AFX-Asia Financial News, April 22, 1998.)

[63] World Bank (1994, p. 200).

[64] Robison (1986, Table 5.4, p. 171) and EIU (1996, p. 14).

Conclusion

From this brief overview of the SOEs' size, scope of activity, and performance results, it appears there are several dominant trends pointing toward a weakening of the SOE's size and influence. SOEs as a CPC constitute a powerful group of enterprises that has successfully managed to maintain a commanding position in Indonesia's economy despite profound changes in the economic structure since 1986. This situation, however, is likely to change. Their primary channel of influence (the technical departments that oversaw them) has been greatly weakened by the October 1997 decision to transfer oversight authority to the Ministry of Finance. This should contribute to a significant decline of SOEs' influence. Yet, although the situation is still too fluid as of this writing (early 1999), if Indonesia were to revert to a more closed economy, relying on economic nationalism to try to get the economy back on track, it could be the case that the SOEs would, once again, play an important role in the economy.

Reform efforts launched after 1986 have been moderately successful; yet oil and gas and state bank sectors are less profitable than other SOEs. These reform efforts have not included the widespread privatization of SOEs, despite calls by the government and the President to do so, thus suggesting the strength of SOEs in opposing policy decisions that run counter to their vested interests. Partial privatization efforts, however, have generated extra government revenue that have been used to repay high-interest public debt. Fiscal requirements to cope with the 1997-1998 fiscal crisis demand an acceleration of the privatization process, but inextricable political obstacles (potential buyers are Sino-Indonesian, Suharto's kin, or foreign firms) make a big-bang approach to privatization impossible. Nevertheless it is likely that privatization will accelerate and further weaken SOEs' influence.

In terms of dynamics, the SOEs' influence will decline as they decline in size, and as the financial intermediaries of their power—the state-owned banks—and their main source of funding—the oil and gas sectors—lose ground to the faster-growing private sector.

SUHARTO AND KIN CPC

Description

The CPC composed of the close relatives of President Suharto is the best illustration of a privileged group, as defined by Mancur Olson—i.e., a numerically small group in which one person is able to deliver all of the collective goods. President Suharto has assumed this role given his position as the head of state. Not surprisingly, in line with Olson's predictions, this CPC has been the most effective at transforming its influence into political power in recent years. The passing of the presidency to Habibie and the popular resentment against Suharto family members are likely to severely curtail that influence.

The consideration of the Suharto extended family should be seen not only in the context of influence of the first family's influence, but also in the context of the development of indigenous capital. In his seminal work on *The Rise of Capital* in Indonesia, Robison (1986, p. 329) divides major indigenous business groups into three categories.

- The survivors of the Benteng [import licensing system] and Guided Economy periods (under Sukarno)
- Politico-bureaucrats of the New Order establishing private business groups
- New capitalists who have emerged with the patronage of the new centers of power.

For the most part, the first category has disappeared as a group. The only important business group which has successfully survived is the largest family-owned *pribumi* group, the Bakrie group. The group is now under the direction of Aburizal Bakrie, the eldest son of the founder Achmed Bakrie, an Arab/Indonesian businessman. The family owns three holding companies: the listed Bakrie & Brothers group (one of the ten largest raisers of capital on the Jakarta Stock Exchange, see Table 4.3), and Bakrie Nusantara and Bakrie Investindo—neither of which is publicly listed.

Likewise, the third category—mostly made up of retired officials, *e.g.*, a former mayor of Jakarta or retired generals—has disappeared for the most part from the scene of *pribumi* business.

Therefore, what is left today of a separate pole of *pribumi* capital in Indonesia is essentially that of Robison's second category—Suharto's family.[65] This group has changed profoundly between Robison's writing in 1986 and today. After listing the various businesses of Suharto's family, Robison correctly underlines the fundamental weakness of these concerns: "[t]he Suharto group does not integrate ownership of capital with ownership and management of a corporation."[66] The most profound transformation of the Suharto group has been to do precisely that—to integrate ownership with management and set up active business groups, as opposed to joint ventures with minority equity. Whereas the President and his wife mostly used foundations (*yayasans*) and participation in Liem's companies to promote their financial interests and increase their wealth, the President's children have set up conglomerates that are consequential in size (with Bimantara group in the Top 10, see Table 4.2).[67] The management of these conglomerates has required Suharto's kin to articulate a set of interests worth promoting and defending. Their unusual leverage with the highest office no doubt warrants our treatment of their groups as a distinct CPC.

The reasons behind the successful transformation—from a business standpoint—of the Suharto CPC are open to conjecture. It is quite clear, however, that the deregulation of the economy starting in the latter part of the 1980s provided Suharto's kin with business opportunities in which their leverage with the presidential office could be best used. The old system of concessions and import monopolies lent itself to the *cukong* system, while the new economic environment was, and is, much more favorable to entrepreneurship. In addition, as mentioned above, the death in April 1996 of Suharto's wife, Mrs. Tien, unleashed the financial appetite of Suharto's six children. Whereas she used to closely monitor their activities and make sure that they would not abuse the system, the President did not do that. He grew more remote from daily activities since becoming a widower and acceded to most of his children's demands. In particular, he did not hesitate to face

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[65]The Sutowo group (Ibnu Sutowo, former director of Pertamina until the Pertamina financial crisis in 1976) was very important and diversified, with large Suharto participation. It is unclear to what extent the Suhartos inherited Sutowo's businesses.

[66] Robison (1986, p. 349).

[67]For a listing of the Suharto's family interests in 1986, see Robison (1986, Table 10.3, pp. 344-345).

significant international opposition to help his youngest son, Tommy, both in the clove business and in awarding him the National Car project (see below).

Despite numerous anecdotes about the influence of the Suharto family in the Indonesian economy, no analysis with a decent level of aggregation has yet been performed.[68] There is no denial that the wealth of the Suharto family is consequential, but this section focuses on the Suharto extended family as a CPC.[69] This section attempts to provide some background about Suharto's kin and evaluate their activities and influence as a CPC.

The launch of the fourth five-year development plan (Repelita IV) in 1984 marks a watershed in the role played by the members of the first family. Until then, most of the commercial activities of Suharto's kin were carried out through foundations, *yayasans*, with the support of long-time friends like Bob Hasan or Liem Sioe Liong. Among the foundations set up early in Suharto's rein are Dharmais, Supersemar, and Dakab. Through these *yayasan,* Suharto and his family hold stakes—and a share of profits—in a dozen large enterprises, including the fourth largest private bank (Bank Duta), an insurance company (Asuransi Timur Jauh), and rice, textile and flour milling concerns controlled by Liem Sioe Liong.[70]

In the wake of the deregulation of the economy (officially recognized with Repelita IV in 1984), Suharto's sons and daughters (six in total) established several companies that quickly expanded into large and diversified conglomerates. Through their connections, Suharto's relatives have been able to obtain exclusive distribution agreements for product categories or sectors of industry that were deregulated. For example, Pertamina's oil monopoly has been gradually pried loose since 1988, and Suharto relatives have been among the biggest beneficiaries (*e.g.*, exclusive rights to export LNG to Taiwan for the Humpuss group). In May 1998, Pertamina rescinded

[68]For a comprehensive review of the 'old' Suharto empire, see Robison (1986, pp. 343-350). Two recent books by former corespondents for the *Far Eastern Economic Review* in Jakarta add their share of anecdotal evidence about the 'new' Suharto interests, but unfortunately do not provide a comprehensive review of the issue. See Schwarz, (1994) and Vatikiotis (1994).

[69]A 1993 survey revealed that four of Suharto's children and Probosutedjo and Sudwikatmono (Suharto's half brother and cousin, respectively) were among the 13 wealthiest non-ethnic Chinese Indonesians (Schwarz, 1994, p. 144). In 1997, Suharto's sons were the eighth, ninth, and fourteenth largest taxpayers in Indonesia. (Thoenes and Ridding, May 19, 1998.)

[70] Vatikiotis (1994, p. 51).

its exclusive contracts with two import agents controlled by two of Suharto's sons—Bambang and Tommy.[71]

Table 4.7 offers an aggregate view of the conglomerates controlled by Suharto's kin. It is important to note that the size of this CPC is only a fraction of the Sino-Indonesian conglomerates or the SOEs. The revenue of these eight conglomerates combined only represent 23.2 percent of the revenue of the Salim group alone in 1995. The figure for assets is 33.4 percent. As a share of GDP, revenue represent only 2.3 percent, while assets represent 3.0 percent.

We provide below a more detailed view of the activities these conglomerates are involved in. This information is very incomplete and has been pieced together from various sources.[72]

Bimantara Group: Founded by Suharto's second son, Bambang Trihatmodjo ('Bambang'), includes the husband of Suharto's daughter Tutut, Indra Rukmana, and Suharto's oldest son, Sigit. The group started operations in 1982. The decisive impetus for growth came in 1984, when the group received monopoly rights for the import of plastics. By 1995, the group had grown to include an estimated 54 companies, with total assets of US$ 1.2 billion and sales of US$ 1.7 billion (see Table 4.7). It is now composed of seven core businesses: telecommunications, media and broadcasting, infrastructure, transport, chemicals, hotels and properties, and financial services (Bloomberg Business News).

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[71] Thoenes and Ridding (May 19, 1998).

[72] Among the best sources were, in addition to Robison (1986), Schwarz (1994), and Vatikiotis (1994), Montagu-Pollock (1995/1996) for an excellent Who's Who in Indonesia; and various issues of the *Far Eastern Economic Review.*

Table 4.7

CONGLOMERATES CONTROLLED BY SUHARTO'S KIN (1995 ESTIMATES)

Group	Main Owners	Relation to President Suharto	Main Business Line	Estimated Revenues (US $ million)	Estimated Assets (US $ million)	Estimated Number of Companies	Estimated Number of Employees
Bimantara Citra	Bambang Trihatmodjo, Indra Rukmana	2nd son, Son-in-Law (husband of "Tutut")	General Trade, Property, Chemicals	1,679	1,186	54	11,000
Humpuss	Hutomo Mandala Putra	Youngest son	Transportation, Oil, Chemicals	916	693	48	1,625
Citra Lamtoro Gung	Siti Hardijabti Hastuti Rukmana	Eldest daughter (wife of Indra Rukmana)	Toll Road Contractor	412	758	46	2,400
Semen Cibidong	Hashim Djojohadikusomo	Brother-in-Law of Suharto's 2nd daughter, Titit Prabowo	Cement, Chemicals	394	1,496	15	2,750
Subentra	Benny Suherman, Sudwikatmono	Sudwikatmono: Cousin	Films and Cinema, Chemicals	377	442	23	1,700
Mercu Buana	H. Probosutedjo	Half-brother	General Trade, Agro-Industry	294	143	64	12,100
Arseto	Sigit Harjojudanto	Oldest son	Chemicals	216	1,026	12	1,900
Datam	Siti Hediati Hariyadi Prabowo	2nd daughter (wife of Maj. Gen. Prabowo Subianto)	Banking, Fuel Distributor	136	119	35	2,050
Total				4,425	5,864	297	35,525
As a Share of Salim Group (1995)				23.21%	33.43%		
As a Share of GDP (1995)				2.29%	3.04%		

Source: *Warta Ekonomi*, June 24, 1996 (http://www.indobiz.com/company/wartpublic.htm) and *Warta Ekonomi*, October 7, 1995 (http://www.indobiz.com/company/ebrieb951007.htm#W2).

Note: Exchange rate is Rp/$ 2,308 and 1995 GDP at current prices is Rp 445,401 billion (EIU, 1996, pp. 75 and 90). Salim Group data are presented in Table 3.2.

Bimantara Citra, the group's holding company, is the only parent company owned by Suharto's family to be listed (though some individual companies of the other groups are listed) on the Jakarta Stock Exchange and has a market capitalization of Rp. 3,356 billion, about US$ 1.5 billion at a RP/$ exchange rate of 2,200.[73] In terms of market capitalization, it is the second biggest *pribumi* (indigenous, non-ethnic Chinese) group in Indonesia (after the Bakrie group).

Citra Lamtoro Gung Group: Founded by eldest daughter Siti Hardijabti Hastuti Rukmana, 'Tutut,' together with her husband Indra and her two younger sisters. The group started its activities with private toll roads in Java and has expanded into distribution (license to import the Proton, the Malaysian-built car), the first nationwide private TV channel, etc. The group had revenue of US$ 400 million in 1992. Tutut has a 16 percent share of Liem Sioe Liong's Bank Central Asia, although it is unclear whether this holding is included in Citra Lamtoro or whether it is a private investment.

Humpuss Group: Founded by Suharto's youngest son, Hutomo 'Tommy' Mandala Putra. The group has exclusive distribution contracts for two important petro-chemical products manufactured by Pertamina, the exclusive concession to export liquefied gas to Taiwan, and, more recently, was chosen as the domestic partner for the Timor national car project. All these deals have been canceled under the IMF agreements. In 1989, with Bob Hasan, the group bought majority control of a charter company from a holding company controlled by the Air Force PT Tri Usaha Bhakti (TUB). The company, Sempati, eventually became the first privately-owned Indonesian airline and broke Garuda's airline monopoly (see the section on the military, above). The company had to suspend operations after the onset of the crisis in July 1997. Tommy also controlled the lucrative monopoly of clove (used in Indonesian cigarettes, or *kretek*), which was also eliminated under IMF pressure. The operations we could identify in which he was involved all seem to have been halted (although it is unclear if Tommy still has or not some exclusive export rights with Pertamina).

[73]Given the great fluctuations in exchange rate, we only provide conversion at the pre-crisis exchange rate. Similarly, the data presented here do not account for the dive of listed stocks on the Jakarta Stock Exchange.

Sigit Harjojudanto: Oldest son of President Suharto, 'Sigit' has interests in many of his siblings' businesses but does not take an active management role in any of these (his nickname is the 'gambling king'). He has minority holdings in many of Bambang's companies, and is thought to hold 40 percent of Humpuss group. Like his older sister, Tutut, he has a 16 percent stake in Liem Sioe Liong's Bank Central Asia.

Sudwikatmono: Cousin of Suharto. He controls the importation and distribution of films. He has a 10 percent share in most of Liem's ventures (it is sometimes argued that his shares in some of these investments are, in fact, in the name of President Suharto himself), and is as well as a commissioner of Indocement (the cement company of Liem). As part of the agreed reform measures with the IMF, subsidies to cement manufacturers must be curtailed, which should hurt Indocement operations. Sudwikatmono also has shareholdings in Bimantara's chemical plants.

Probosutedjo: Half-brother of Suharto. He is a vocal supporter of the emancipation of *pribumi* business. In the 1970s, he shared the lucrative monopoly of clove with Liem Sioe Liong. His companies span a wide array of industries in construction, glass-making, and agro-business.[74] He heads the Association of Indigenous Indonesian Businessmen, as well as the Supervisory Council of KADIN, the Indonesian Chamber of Commerce and Industry.

Hashim Djojohadikusomo: Brother-in-law of Suharto's second daughter, Titiek Prabowo, and of the governor of Bank Indonesia. He owns Semen Cibinong, a leading cement manufacturer, now listed on the JSX (see Table 4.3), with sales of Rp 536.6 billion (approximately US$ 250 million), which will also be negatively affected by the end of subsidies. In addition, Hashim was involved in a large venture to build Indonesia's second olefins plant in joint venture with TransPacific Petrochemical (UK), which has probably been suspended.

This cursory overview of business interests of Suharto's kin reveals two important features and leads to two conclusions. First, the pattern of capital accumulation is very similar to that of the Sino-Indonesians under the *cukong* system. In the case of

[74] Schwarz (1994, p. 143).

Suharto's kin, they have traded their access to the President against participation in business ventures or obtain lucrative monopolies of products spun off from SOEs—*e.g.*, monopolies of some petro-chemical products that used to be controlled by Pertamina. Yet, the entrepreneurial skills of these cronies should not be underestimated and, except in the case of Sigit, the owners take active interest in the management of the groups. These groups, whether Bimantara or Citra Lamtoro Gung, are expanding and taking risks in new markets that are just opening up.

However, this risk-taking behavior is rational insofar as failed ventures do get rescued with either public money (*e.g.*, the bailout, through credit from state banks, of the Humpuss group after its failure in the clove business, or through the financial help of Sino-Indonesian friends who get rewarded later on for their "contribution").[75]

The second important feature of the CPC of Suharto's kin is that most of its investment and concerns lie in the domestic Indonesian market, most often in joint ventures with ethnic Chinese, SOEs, or foreign firms. The most international of the groups is the Humpuss group, which specialized in obtaining import or export monopolies. This process of capital accumulation by Suharto's kin has one positive aspect in the sometimes tense Indonesian ethnic climate. Although related to the former President, these groups are also indigenous (*pribumi*) groups. It is not surprising, therefore, to see Suharto's kin take the mantra of *pribumi* emancipation to justify the preferred treatment they receive. It seems clear, however, that the Indonesian public was not dupe.

Overall, the Suharto and kin CPC has been the most severely hit of all CPCs by the recent crisis. Since they derived most of their revenues from special concessions, monopolies, etc., it is clear that they will not return to their former heights even if the Indonesian economy were to quickly recover.

Channels of Influence

The channels of influence used by Suharto's kin were, unsurprisingly, their privileged access to the former President. In their own business operations, they have used this

[75] For example, Bank Duta was bailed out through a capital injection from Liem and Prajogo Pangestu—two ethnic Chinese businessmen. They were rewarded a month later with the right to be the principal domestic partners in a giant oil refinery project with Fluor Daniel of Irvine, California.

access to obtain privileged information (*e.g.* about a state monopoly about to be adjudicated or about a major government contract) before their potential competitors and could thus position themselves to win over the competition or to place themselves on the winning team. In addition to their own operations and ventures, they have been actively courted by groups that needed a 'local' partner with access to the presidential ear. Several cases of partnership with Sino-Indonesian conglomerates are a case in point, but many foreign consortia in mining exploration, large petro-chemical, or telecommunication projects have also sought to include a Suharto relative in their consortia to bypass red tape and to win acceptance for their project over their competitors.

It is important to note that, in most cases, tender for major projects are fought among several teams of companies, each including a different member of the Suharto clan. There is ample anecdotal evidence of such deals. One of the more interesting cases is the 1988 bid for telecommunications switching equipment that saw three groups, each with a different member of the clan, vying for a US$ 300 million contract. There was first a selection down to two teams. The team eliminated included Bambang, who was already the designated local manufacturer, regardless of the company selected for the contract. His share was assured. In November, 1990, in a Solomon-like decision, the contract was doubled in size, with each team winning half—i.e., each deriving the benefits of the original tender.[76] The President could not bring himself to choose among his immediate family members.

The more recent case of the National Car Project is, again, direct evidence of the myopia of President Suharto when it came to defending the interests of his children. The project has alienated close Sino-Indonesian supporters (*e.g.*, the automotive Astra group which, of course, does not complain openly about it) and virtually the entire international community, from Japan to the E.U. to the United States. (This project will be further discussed in the next chapter.)

To conclude the discussion of channels of influence used by Suharto's kin, the issue of corruption should be briefly addressed. Although we consider corruption in this framework to be the extreme case of the use of personal channels of influence, the

[76] Schwarz (1994, p. 145).

deleterious effects of corruption cannot be overlooked.[77] Although Sino-Indonesians have long used corruptive means to advance their interest (*e.g.*, co-optation of influential members of government on their boards or direct financial compensation through participation in business ventures), simmering resentment against their wealth has served as a powerful brake to their corruptive zeal. Money can buy many things in Indonesia, but not one's ethnic identity. Suharto's kin, on the other hand, have extensively used corruptive means of influence; the mantle of *pribumi* emancipation has fueled their drive rather than slowed it down. We wrote in the first draft of this document (completed in June 1997) that *the buildup of resentment generated by such behavior may come to haunt Suharto's kin in the future.* Subsequent events have confirmed this assessment.

KADIN AND THE RISE OF A *PRIBUMI* CPC

Earlier, we have mentioned KADIN, the Indonesian Chamber of Commerce and Industry, as an institutional platform for business people. Since the inception of the New Order in 1966, Suharto's regime developed a vast array of state-sponsored corporatist business associations (for example, the Real Estate Association, the Shipowners' Association, or the Architects' Association).[78] These professional associations are very similar to their counterparts in other countries, except for the fact that they are, with very few exceptions, powerless. At the center of this web of associations stands KADIN, the Indonesian Chamber of Commerce and Industry. KADIN is meant to be the "peak organization for the articulation of business interests."[79] It is a creation of the New Order (founded in 1968) and has been basically toothless for most of its existence. MacIntyre's detailed case study analysis of three industries (spinning, pharmaceutical, and insurance) reveals that KADIN is an instrument of the state. Even senior members of KADIN interviewed by MacIntyre dismissed it.

[77]On this point, see Bardhan (1997) and Kaufmann (1997). In 1997, Indonesia was ranked the 46th most corrupt nation out of a sample of 52 nations (Transparency International, 1997 annual survey). See also the already mentioned study of Ozay Mehmet (1993) estimating corruption among top-level bureaucrats.

[78]One of the only truly independent associations is that representing the spinning industry, Sekbertal, which is financed through the dues of its members, and not the government (MacIntyre, 1992, pp. 88-99). This entire section on KADIN is based on MacIntyre (*ibid.*, pp. 43-56) and Schwarz (1994, pp. 119, 125).

[79] MacIntyre (1992, p. 41).

In many respects, KADIN is similar to the Association of Merchants under Edward III. It is a creation of the "monarch," and is meant to control, rather than to represent business interests. Like its faraway medieval cousin, KADIN will probably prove too unwieldy to Indonesian businesspeople. They will, in time, want some independent representation of their interest, most probably through Parliament.

Aside from the (national) executive, KADIN has three branches: (1) the regional KADIN branches (KADINDA), (2) the 'aspiration groups,' and (3) the sectoral or sub-sectoral industry associations. Although the organizations belonging to the first two branches are basically useless in terms of business representation, real representation of business interests can be achieved at the sectoral or sub-sectoral level. While most of the associations are passive and docile, some do actively represent and promote the interests of their constituents (see the three case studies discussed by MacIntyre). Such representation, however, is limited to policies directly relevant to a particular industry and, in no case, does it address larger policy issues. As such, these associations act as traditional trade associations and not general business associations like CPCs.

To supplement its meager support from the government, KADIN used to benefit from handouts from a few wealthy Sino-Indonesians. Yet it appears that KADIN has recently become the primary channel of influence, not of the Sino-Indonesian community, but rather of the *pribumi* entrepreneurs. One of the most vocal defenders of *pribumi* interests is Probosutedjo, Suharto's half-brother. As head of the Association of Indigenous Indonesian Businessmen (HIPMI, part of the second branch of KADIN) as well as the Supervisory Council of KADIN, he has had excellent institutional platforms from which he could vent his frustration with Sino-Indonesian tycoons.[80]

Nonetheless in January 1994, and perhaps as a sign of the growing frustration of leading *pribumi* entrepreneurs with the first family, KADIN members elected Aburizal Bakrie to head KADIN instead of President Suharto's candidate, Abdul

[80] In December 1993, the KADIN's Supervisory Council published a report, signed by Probosutedjo, full of vitriolic comments against predatory Sino-Indonesian entrepreneurs. In a direct rebuke to the thesis that deregulation is to everybody's advantage, the report claimed that "each new deregulation package worsens the economic imbalances because it allows [Sino-Indonesian] big business to expand and grow through unfair competition" (Schwarz, 1994, p. 125).

Rachman Ramly, former head of Pertamina and former Ambassador to the United States.[81] By electing Bakrie, *pribumi* entrepreneurs strongly indicated their disapproval of the President's cozy relationship with the Sino-Indonesians. This was one of President Suharto's rare defeats. The growing assertiveness of the *pribumi* entrepreneurs points to the possibility of an emerging independent *pribumi* CPC, not connected to the first family.

This report does not consider *pribumi* businesses as a separate CPC for three reasons. First, the aggregate size of this group of firms (less than 15 percent of private industry) is still too small to be considered a separate CPC. Second, the average size of the *pribumi* firms does not allow them to influence policy in any significant manner, except through rare and sometimes successful collective action (*e.g.*, MacIntyre's examples). Third, as Mohammad Sadli, personal economic advisor of President Suharto, observed several years ago: "The *pribumi* businesses are all lumped together in engineering and construction. This is hardly surprising. They all got their start through government contracts to build infrastructure during the latter years of the oil boom."[82] Although this situation has changed over recent years, the breadth of *pribumi* businesses cannot be compared to that of the Sino-Indonesians.

Events since May 1998 (fall of Suharto) suggest that, in the not too distant future, *pribumi* firms should be considered as a separate CPC with specific interests and channels of influence. The stepping down of President Suharto highlights the growing discomfort, if not outright antipathy, of the *pribumi* middle class toward the New Order. The two key policies of interest to a *pribumi* CPC are: (1) anti-trust legislation to break up the large Sino-Indonesian conglomerates, and (2) whether to pursue a system of preferential government contracts (positive discrimination) instead of simply leveling the competitive playing field (equal treatment).

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[81]Schwarz (1994, p. 125) and Winters (1996, pp. 428-429).

[82]Schwarz (1994, p. 118). Most of these government contracts stemmed from the so-called Team 10 effort (1980-1988) to hand out government contracts on a preferential basis to *pribumi* businesses, a policy very much like the U.S. preferential allocation of government contracts to businesses controlled by minorities.

FOREIGN SECTOR CPC

Description

As we have previously mentioned, we do not include oil and gas-related companies in the CPC composed of foreign firms. The reason is that the energy sector is extremely insulated from the domestic economy. The activities of foreign firms in that sector and their interaction with Pertamina and PLN (the public utility company) are fundamentally different from those of the domestic economy. Oil and gas are basically controlled by foreign firms through 30-year concessions, although ownership remains Pertamina's. Most oil production in Indonesia takes the form of Production Sharing Contracts (PSCs) under which the foreign concession contributes all the capital, and shares the revenue with Pertamina—which retains ownership—on a contract-by-contract basis. In 1993, total crude oil and LNG production was 1,504 thousand barrels per day (TBDs). Out of these, 1,429 TBDs (95%) were in the form of PSCs. Pertamina itself produced only 75 TBDs (5%).[83] Although these foreign firms clearly constitute a unique CPC, we chose not to study it and focus instead on the domestic, non-oil and gas economy.[84]

The history of foreign businesses in Indonesia since World War II has been very tumultuous. Although the New Order realized that it needed foreign capital to rebuild the ravaged economy left by Sukarno, there remained a deep distrust of foreign money, expressed at every level of the national ideology. In the wake of the 1974 riots, a change in the PMA law (regulating foreign investment) required henceforth all ventures to include national partners, whose equity was to be increased to 51 percent within 10 years. Table 4.8 shows how much foreign investment was needed at the beginning of the New Order to sustain development.

[83] Barnes (1995, Table 3.6, p. 63).

[84] For an excellent overview of the oil and gas sector in Indonesia, see Barnes (1995).

Table 4.8

Sources of Investment Funds—Public/Private

Repelita	Domestic Share Domestic Investment		Domestic Share Total Investment			Foreign
	Public	Private	Public	Private	Total	
II ('74-79)	51.3	48.7	36.8	34.9	71.7	28.3
III ('79-84)	37.3	62.7	29.5	49.5	79.0	21.0
IV ('84-89)	41.2	58.8	33.3	47.6	80.9	19.1
V ('89-94, P)	39.4	60.6	37.0	56.9	93.9	6.1
V ('89-94, A)	27.2	72.8	25.0	67.0	92.0	8.0
VI ('94-99, P)	26.6	73.4	25.1	69.4	94.5	5.5

Key: Shaded area are projections (P), (A) means actual figures.
Source: Compiled from Booth (1989, Table 3, p. 7; and 1994, Table 4, p. 10), Hill (1996, Table 6.6, p. 108).
Note: Year is April 1 through March 31.

The share of foreign investment has declined greatly since the fifth five-year development plan, Repelita V, because foreign investment has not grown as fast as domestic investment.

Table 4.9 offers a breakdown of cumulative investment since 1967 (foreign, PMA) and 1968 (domestic, PMDN). A comparison of patterns of investment for domestic and foreign concerns reveals that foreign investors have tended to invest more in industry than in services since 1980. This pattern reflects limitations on sectors in which foreigner firms could invest.

These aggregate numbers, however, exclude oil, gas, and finance. In the financial sector, it is estimated that 70 percent of all trades on the JSX were conducted by overseas buyers until July 1997. As of May, 1996, 31 of the 197 members of JSX were foreign concerns.[85]

Historically, foreign and domestic investors have responded in like fashion to the commercial environment confronting them. If investment approvals were plotted on a chart, the spikes and direction of change in investment would be the same for both groups.[86] Examining recent data on investment approvals (other than oil and gas or finance), one can see that foreign approval had been increasing since the start of the 1990s, along with domestic investment.

[85] Solomon (May, 1996, p. 50).

[86] See, for example, Hill (1996, Figure 5.3, p. 76).

In an effort to boost foreign investment, the Indonesian government adopted a package of reform measures in October 1993, which was supposed to woo foreign investors. The reform measures were too timid; foreign investment did not pick up. In June 1994, the government issued a new package of reforms.

Table 4.9

Cumulative Share of Foreign and Domestic Investment By Sector, 1980 and 1992

	Foreign		Domestic	
	Up to 1980	Up to 1992	Up to 1980	Up to 1992
Industry	82.8	68.5	80.4	69.0
Manufacturing	67.2	61.4	78.0	67.3
Mining	14.7	6.1	2.0	1.1
Construction	0.9	1.0	0.4	0.6
Services	7.3	28.0	8.0	16.6
Trade, hotels	2.7	11.6	1.6	7.2
Real estate, business services	2.6	11.8	2.8	4.6
Transport and communications	1.7	2.6	3.3	2.6
Other	0.3	2.0	0.3	2.2
Agriculture	9.8	3.4	11.6	14.4
Total				
Current US $ million	9.0	59.2		102.3
Current Rp trillion			6.8	211.0

Source: Adapted from Hill (1996, Table 5.4, p. 78).

Figures are cumulative up to 1980 and up to 1992, starting in 1967 and 1968 respectively for domestic and foreign.

The new regulations allowed 100 percent foreign ownership, either by foreign nationals/individuals or foreign companies. It still required, however, that within 15 years of commercial activity, foreign ownership be partially sold to Indonesian individuals or companies.[87]

This requirement notwithstanding, the authorization to have up to 100 percent foreign ownership attracted foreign investors back to Indonesia. The boost provided by the 1994 reform package actually led foreign investment approvals to surpass domestic approvals for the year. In the non-oil sector, most investment has been in the petrochemical sector. In 1995, investment in several chemical refineries

[87]Government Regulation No. 20, May 19, 1994 (referred to as the June, 1994 package). See "Law & Regulation" at http://www.bkpm.go.id/law/law.html. For a full text of the key articles, see http://www.prica.org/indonesia/economics/gr_invest.html.

amounted to US$ 19.4 billion, representing 49 percent of total approved foreign investment for the year.[88]

A new deregulation package was adopted in January 1996 which facilitated access for foreign investors to export and import goods through simplified administrative and bureaucratic procedures. Finally, the package of reform measures agreed upon between the Indonesian government and the IMF in October 1997 provides "more" equal treatment of foreign investors. They now have better access to domestic distribution networks, either on their own or with an Indonesian distributor of their choice.[89] Since the beginning of 1998, the worsening crisis in Indonesia has kept foreign investors away. It will take more than improved investment regulations to bring them back.

Table 4.10

Approved Investment Projects, 1990-1996

Year	PMDN	PMA	Share of Value		Total
	$ Million	$ Million	PMDN	PMA	$ Million
1990	30,665.6	8,751.1	77.8%	22.2%	39,416.7
1991	20,621.4	8,778.0	70.1%	29.9%	29,399.4
1992	14,229.7	10,323.2	58.0%	42.0%	24,552.9
1993	18,696.9	8,144.2	69.7%	30.3%	26,841.1
1994	24,222.3	23,724.3	50.5%	49.5%	47,946.6
1995	30,265.6	39,914.7	43.1%	56.9%	70,180.3
1996*	38,885.6	26,532.6	59.4%	40.6%	65,418.2

Source: Indoexchange (1997, Table 1).
Data for 1996 are only for January through October. Through December, PMA amounted to US$ 29.9 bn. (U.S. DoC, 1997a).
Exchange rates are from EIU (1996) and from U.S. DoC (1997b) for 1996.

Channels of Influence

The foreign sector has no established institutional channels of influence in Indonesia. Foreign investors rely on personal channels of influence to access policymakers. They also rely on the well-functioning system of bringing local partners with relevant connections into their joint ventures. The most sought-after partners are Suharto's kin, yet several large projects involve partnership with Sino-Indonesian

[88] U.S. Department of Commerce (1997b).

[89] This loosening of rules governing access to domestic distribution networks will be phased in through 2003 (see *Communications from the U.S. Embassy in Jakarta*, 1997).

conglomerates as well. Again, the contrast with the oil and gas sector is large. Foreign companies involved in oil and gas or in minerals extraction do not seek such local partners, because their activities are for the most part insulated from the domestic economy. They rely mainly on personal contacts to promote and protect their interests.

In addition to their own political (influence-seeking) activities, foreign investors have their interests *de facto* protected by international lending agencies like the World Bank, the IFC, and the IMF. There often is congruence between the interests of foreign investors and the policy prescriptions of these agencies, and hence foreign investors benefit from pressure on the Indonesian government from these international organizations. Foreign investors also sometimes ask for direct help from their own governments to have some policy adopted. For example, U.S. investors lobbied Washington to obtain a fairer bilateral tax treaty with Indonesia.

The next chapter incorporates the information of this chapter and articulates policy objectives with CPC interests.

Chapter Five

ARTICULATING CPC INTERESTS WITH POLICY ISSUES

INTRODUCTION

This section serves as the second component of the illustration of the CPC methodology.[1] The section first presents four policy issues central to the reform measures requested by the IMF—i.e., banking supervision, SOE privatization, trade liberalization, and investment deregulation. For each policy, we provide some historical background and articulate the inferred position of each CPC with respect to the policy. We also provide a graphical representation of the effects and leverage of CPCs on the various policies. The section concludes with a summary policy matrix which presents the articulation of policies with CPCs' interests in one table.

Competing Views of Economic Development, CPCs, and the Unraveling of the Technocrats' Consensus

The competing views of Indonesia's economic development during the first three decades of Suharto's rein can be reduced to two organizing visions. On the one hand, "technocrats" were basically the proponents of free-market orthodoxy while, on the other, "technologists," believed in state-led economic nationalism.[2] Whereas the former advocated export-led industrialization with limited import protection, the latter preferred industrialization based on import substitution. Technocrats wanted to use Indonesia's comparative advantage of cheap labor to further economic

[1] Given the rapid changes that have taken place in Indonesia in 1998, it is more useful to present the illustration using the situation prevailing in the quasi-market for influence at the eve of the crisis in July 1997. The section therefore serves as a postmortem of Suharto's last few months in power, highlighting how CPCs had come to be in a position to block all the major reforms that the international community, and the domestic middle class, would request.

[2] See, for example, Schwarz (1994).

development, while technologists wanted to strengthen Indonesia's "competitive advantage" with the nurturing (at the state's expense) of "strategic" (mostly high-tech, capital-intensive) industries.

Despite this gap in strategies, however, the technocrats gathered a policy consensus around a core set of macro-economic policies: exchange-rate, monetary, debt-management, and fiscal policies.

- Exchange-rate policy: continued commitment to a managed float system, with free capital account
- Monetary policy: control of the money supply with open market operations and money market securities and the targeting of the price of money by setting discount rates
- Prudent debt management: control of the total debt burden (never in three decades has Indonesia defaulted on its sovereign debt)
- Fiscal policy: continued commitment to the "balanced budget " rule.

By and large, Indonesian policy elites (both technocrats and technologists) and all CPCs shared this set of objectives. It is in the implementation of these policies, as well as in their timing, that discordant views arose. The 1997 economic crisis affected this consensus, but in ways that are difficult to assess at the moment. The four pillars of macroeconomic stability lie now (early 1999) in shambles. The Habibie Administration will need to decide whether to revert to the former system or whether to adopt a new framework of monetary and exchange rate policy. Private commercial debt spun out of control, bringing Indonesia to her knees. The Habibie Administration will need to address this issue as a first priority, so as to restore access to foreign financing. Finally, prudent fiscal policy has all but been forgotten in the months leading to Suharto's fall. Given Habibie's record, it is not clear how much priority he will attach to this pillar of stability.

Along with destroying the pillars of macroeconomic stability, the crisis has seen the rapid dismissal of the remaining technocrats advising President Suharto. Through repeated tensions and standoff situations with the IMF, the consensus seemed subject to wild swings, reflecting the push and pull of various interests. Such a situa-

tion, however, is not particular to Indonesia. Economic crises have wrecked the policy consensus prevailing in many other developing countries.[3]

To a large extent, however, the technocrats' consensus was forced upon Indonesia, not by the technocrats, but by demographics.[4] Each year, 2.3 million Indonesians enter the workforce (81 million in 1993; 91.6 million projected in 1998). According to the World Bank, Indonesia needs to sustain a non-oil GDP growth of 6-7 percent *p.a.* to absorb the throngs entering the labor force at rising levels of productivity. One percentage lower growth means 320,000 fewer jobs created in a year's time.[5] Most of the labor absorption must take place in non-agriculture sectors (65 percent, with approximately 20 percent each for manufacturing, trade, and "other sectors").[6] In concrete terms, when it is forecasted that Indonesian GDP growth rate may be null (i.e., a 7.5 percentage-point drop from 1996-1997), it means that about 2.4 million young workers will not find employment, in addition to the several million workers that are out of work because their companies cannot repay debts.[7]

Textbooks and policy speeches don't make policy; people do. Before reviewing some of the policy issues facing Indonesia, we want to identify the key figures of this technocrat/technologist divide. The technocrats are often referred to as the "Berkeley Mafia" because of their training in economics at the University of California at Berkeley. They were led by Widjojo Nitisastro and Ali Wardhana. Widjojo was head of Bappenas (National Development Planning Board) from 1967 to 1983 and Minister of State Co-Ordinating Economics, Finance, Industry and Development from 1973 to 1983. Ali Wardhana served as Finance Minister for three terms before becoming Coordinating Minister for the Economy in Suharto's fourth term. From 1988 through the beginning of 1998, the two were Suharto's principal economic advisors. Widjojo, widely regarded as the architect of Indonesia's economic development, remained one of the closest and most trusted economic advisors of President Suharto through-

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[3] For a discussion of the impact of such crises on emerging market economies, see Hausmann (1997).

[4] Although the argument is not explicitly flushed out in this report, the near collapse of the Indonesian economy in late 1997/early 1998 suggests that the internationalization of the Indonesian economy may be an even more powerful constraint on economic policy than demographics. While the latter only requires the creation of jobs, the former requires the creation of *competitive* jobs.

[5] World Bank (1994, p. 43).

[6] See World Bank (1994, p. 43) and Mehmet (1994, pp. 178 and 186).

[7] The most recent figure suggesting an economic contraction of 10 percent means that 3.2 million new entrants in the labor force will not find work in the coming year.

out his term in office, as did Ali Wardhana.[8] It is a measure of the crisis that has hit Indonesia that Suharto distanced himself from them in the last months of his rein. It also demonstrates the pressure placed on Suharto by competing CPCs—chiefly the Sino-Indonesians and his family members.

Early technologists came mostly from Pertamina (the state-owned oil monopoly), Kostrad (Army Strategic Reserve Command), and Opsus (Special Operations, the political and intelligence center of the military). The push for more state-led capitalism came from the leaders of these institutions, Ibnu Sutowo (President Director of Pertamina), and General Ali Moertopo and Soedjono Hoemardani, leaders of Opsus.[9] Increased oil revenue and the perception of a lesser need for foreign capital and fiscal conservatism led to their increased clout during the oil boom (1975-1985).

The champion of their cause is no other than the new President, Bacharrudin Jusuf Habibie. He seemed to favor targeted protection of key strategic (mostly high-tech) sectors. In 1993, he said: "Deregulation policies should be directed at non-priority sectors and formulated in ways that help the priority industries."[10] In addition to direct capital injection, these priority industries are shielded from competition.[11] Habibie's efforts have focused on ten capital-intensive strategic industries, ranging from aerospace to steel and shipbuilding (see section on SOEs in previous chapter). They are grouped under, and regulated by the Coordinating Agency for Strategic Industries (BPIS). BPIS was placed directly under Habibie's supervision (it is now under his brother's), not that of line ministries, as was the case for other SOEs before October 1997. The ten strategic industries have required billions of dollars of capital injection, and have produced no significant achievements.

The crucial question, however, is not who the future "technocrats" or "technologists" will be; but, rather, whether any small group of people will be able to control and

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[8]Other often-heard technocrat personalities are former Ministers of Mines and Energy Mohammad Sadli and Subroto (personal economic advisor to the President); the former economic minister Radius Prawiro; Emil Salim, Deputy head of BAPPENAS; and Johannas B. Sumarlin, who held several key portfolios, including Finance. For more information on the technocrats, see, among others, Robison (1986, footnote 6, p. 127) and Schwarz (1994, pp. 52-53).

[9] Robison (1986, pp. 148-151 *passim*).

[10] Quoted in Schwarz (1994, p. 86).

[11]In May 1995, a presidential decree redefined the list of sectors closed to foreign and domestic investment, unless specific conditions were fulfilled (*e.g.*, technology transfer). All aircraft-related investment (one of the ten strategic industries) falls into this category (see http://www.bkpm.go.id/other/appen1.html for details).

steer Indonesia's economic development as decisively as the older generation of technocrats did. Again, within the limited scope of this study, we cannot fully address this complicated issue. Suffice it to say that, in pre-1986 Indonesia, the economy was largely sheltered from outside (i.e., non-state or foreign) influence. In such an insulated economy, the clear vision of a few policymakers could—and did—steer the economy in one chosen direction. Since then, however, key sectors of the Indonesian economy have been liberalized and deregulated. The liberalization of the economy has generated a multiplication of economic actors. This has led to the need for nonmarket institutions to meet the demands of multiple market actors. The challenge to President Habibie's administration will be to develop these institutions, without which his rein will remain as paralyzed as Suharto's last months in office.

A less regulated economy has blunted the tools of central economic policymaking, making it a far more challenging task. Similarly, the internationalization of the economy has forced upon Indonesia a set of economic policies that is independent of the judgment or inclination of any one "technologist" in Indonesia. In this new Indonesian economy, policy implementation is becoming more critical relative to policy choice. Successful implementation of policies requires more than a few well-trained economists. It requires strong institutions with competent civil servants—whether in government or in companies that are instrumental in implementing economic policy (e.g., the state-owned BULOG, the commodity procurement agency).

The Deregulation Drive—1986-1997

We submit that the 1997 financial crisis—and the ensuing political crisis that led to President Suharto's resignation—constitutes a new milestone in Indonesia's economic development. The package of policy reforms agreed upon between the Indonesian government and the IMF will alter the structure of the economy and the relative strength of CPCs.

During the decade of the oil boom (1975-1985), import substitution and protection became the buzzwords of Indonesia's economic development. In the mid-1980s, Indonesia reeled under the combined effects of a series of external shocks: declining oil revenue, the depreciation of the dollar after 1986, and the rise in international interest rates. Oil exports (in volume) started declining after 1978, but high oil prices

masked this trend. The fall in international oil prices in 1986, combined with the slide in the value of the dollar, caused oil and gas export revenue to dramatically drop to US$ 8.3 billion, from $12.7 billion in 1985 and $16 billion in 1984. (Oil prices dropped from $30 in 1984 to $10 per barrel in 1986.) Higher interest rates made debt servicing all the more painful. The World Bank estimates that these shocks have entailed a combined loss of income for Indonesia of 7-8 percent of GDP *p.a.* during 1983-1988.[12] While the economy grew at an annual rate of 7 percent over the 1968-1981 period, the growth rate slowed down to only 4.3 percent over the 1981-1988 period, but returned to 7 percent over the 1989-1996 period.

Faced with such a dramatic change in its economic position, the Indonesian government—*i.e.*, the technocrats—understood that oil alone would not suffice to spur development and sustain growth. To deal with declining oil revenue and these external shocks, the technocrats developed a two-pronged strategy: (1) restore macroeconomic stability through fiscal and monetary restraint and (2) establish a more diversified and efficient productive base through structural reform, relying less on oil and more on market forces than on the state.

Although the Indonesian government had launched several policy reform initiatives in monetary, fiscal, and banking policies in the early 1980s, it was not until 1986 that the government implemented the first of a long series of fundamental deregulation packages in trade and investment (domestic and foreign), followed by a series of deregulation packages in banking and financial services in 1988-1989. These reform packages have profoundly altered the structure of the economy and have greatly expanded the role of private industry in the economy.[13] As we have described in the previous chapter, the decade of economic deregulation and growth was accompanied by the rise of CPCs and their growing influence on policymaking—leading to the ultimate demise of Suharto.

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[12] World Bank (1994, p. 3).

[13] Rodgers provides a detailed list of policy reforms from 1970 through 1990 (Rodgers, 1993, pp. 41-45). For a list of policy reforms in banking and finance, see Nasution (1994, pp. 155-157), and for a detailed review of the 1988-1989 financial deregulation packages, see Cole and Slade (1992, pp. 98-101).

POLICIES UNDER CONSIDERATION: A GRAPHICAL REPRESENTATION

To illustrate the CPC analysis, we evaluate the position of the four major CPCs—the Sino-Indonesians, SOEs, Suharto and his kin, and foreign investors—with respect to four policies that are at the core of the IMF packages of October 1997 and January and April 1998:

- Monetary policy—strict banking supervision (including potential closing of insolvent banks)
- Fiscal policy—privatization of SOEs to generate revenue and expansion of private enterprise
- Investment deregulation—equal treatment of foreign investors (better access to domestic distribution networks, on their own or with an Indonesian distributor of their choosing)
- Trade Liberalization—deepening trade liberalization and the ending of special treatment for selected projects.[14]

The relative position of CPCs weighs on the chances the reform measures will be implemented. Indeed, the reform measures were directly aimed at some of the CPCs' most important interests. The economic and financial crises and the ensuing political crisis revealed how important these interests were to the CPCs and affected their influence on the President.

At the end of the discussion of each policy, we present a schematic representation to describe the position of CPCs regarding each policy with a two-axis figure (see Figures 5.1 through 5.4). Each figure maps a policy interest—for example, bank supervision or privatization. The horizontal axis measures the *leverage* (i.e., strength of influence) a CPC has on the given policy, while the vertical axis represents the *effect* of the policy on the CPCs. The ranking is ordinal and, for convenience, is scaled from -5 to 5. The analyst or policymaker can rely on the mapping of the policy (1) to evaluate the relative position of the CPCs; (2) to decide whether to implement the policy; and (3) to assess the likelihood of success of the policy.

[14]For details about the specifics of each policy, see *"Communications from the U.S. Embassy in Jakarta"* (November 1997), as well as the different IMF press releases for each package.

On the *leverage* (horizontal) axis, a high positive value signifies a high ability by the CPC to either have a preferred policy implemented or to derail the policy. A low negative value, in contrast, indicates no leverage to have the policy implemented (or blocked). The scale ranges from –5 to +5, from a total lack of leverage to very high leverage, with zero representing a neutral position. Although negative leverage is somewhat counterintuitive, it is useful for a graphical representation with four quadrants (see below). Although the ranking is ordinal and discrete, it can be thought of as cardinal and continuous—i.e., there is no qualitative change around zero.

The vertical axis represents the *effect* of the policy on the CPCs. The effect of a policy can be positive or negative. This effect is not only pecuniary but also can incorporate, for example, bureaucratic control (for ministries regulating SOEs) or position in society (for the Sino-Indonesians). Broadly defined, effect then becomes a gauge of the *view* of a CPC on the policy: Positive indicates support for the policy, while negative effect indicates opposition. The scale ranges from –5 to +5, from strongly beneficial to strongly opposed, with zero representing a neutral.

The ratings of leverage and effect are made in "business as usual" conditions, not in a crisis environment. In the case of Indonesia, the ratings can be thought of as those prevailing at the end of June 1997, before the onset of the crisis. The onset of the crisis leads to a crystallization of the positions of the CPCs with respect to various policies. Once the crisis is under way, these positions become inputs to the trade-off analyses carried out by the government in its search for a solution to the crisis.

Whether explicitly stated or not, these positions help the analyst and the policymaker evaluate policy alternatives and can point toward potential trade-offs or potential political deadends for which the existing government cannot find a solution. Steadfast opposition to a policy, even in the presence of high leverage by a CPC, can be overcome by the government if the situation requires it—but at great political cost. In the case of Indonesia, the cost proved too high to pay, and the President had to resign because he could not deliver the required reforms.

Monetary Policy—Strict Banking Supervision

The World Bank assigns three policy priorities to banking and finance: to ensure stability through a healthy banking system; to improve the access and allocation of credit; and to deepen capital markets.[15] This section focuses on the first priority. Through the oil boom (1974-1982) and until June 1983, stability was ensured mostly through the Bank of Indonesia's direct control and strict regulation of the banking system. Direct control took the form of a policy of credit ceilings imposed on individual banks, as well as direct and indirect subsidization by the central bank of specific economic sectors. Credit allocation requirements had both a regulatory and developmental purpose—namely, assuring control of the money supply (credit ceilings) and targeting special sectors of the economy for preferential lending conditions.

The vehicle for the developmental objective was the central bank itself and the state-owned banks. By 1983, the central bank and the state banks directly controlled 79 percent of total credit (15 and 64 percent respectively). In contrast, private commercial banks only controlled 18 percent (12 percent from Indonesian and 6 percent from foreign banks).[16] Regulatory control effectively allowed near dominance of the banking sector by state-owned banks.

In terms of developmental objectives, the credit ceiling system quickly turned into subsidized credit for SOEs and well-connected Sino-Indonesians. Although rice farmers have consistently been the main beneficiaries of preferential loans (for political reasons), conflicting and uncoordinated objectives (as set in innumerable lists of priority sectors in manufacturing) led to a substantial diversion of credit to well-connected tycoons.[17] By 1983, subsidized lending represented 56 percent of banking sector claims on the private sector (and virtually all claims on SOEs, which were required to use state banks).[18] Not surprisingly, the policy mix reflected the prefer-

[15] World Bank (1994, pp. 82-83).

[16] Direct central bank credit only includes credit; rediscounting of developmental loans by state banks is not included. Regional developmental banks (representing between 1 and 3 percent of total credit) are not included (MacIntyre, 1993, Table 5.4, p. 138).

[17] As MacIntyre summarized it: "One crude indicator of this [widespread credit diversion] is the fact that it was during the 1970s that business people who were associated with key government figures—most important, the president—were able to increase the scale of their business activities dramatically." (MacIntyre, 1993, p. 152.)

[18] Binhadi and Meek (1992, pp. 102-103) provide a good overview of monetary policy for the period.

ences of the Sino-Indonesians and the SOEs. Suharto and his relatives were not involved enough in business activities to have set-preferences this time, while the foreign firms wanted a less regulated banking system and less subsidized credits to domestic firms.

The end of the oil windfall, however, made the continuation of such policies impossible. In June 1983, the credit ceiling system was partially scrapped,[19] and the exchange-rate crisis of 1987 led to a comprehensive change in monetary and financial market policies in October 1988 (the so-called "*Paket Oktober*," or "*Pakto*"). Since then, open market operations and the control of bank reserves have been used instead of direct credit control. The consequence of this liberalization has been an explosion of private banks and the retreat of state-owned banks as the main financial intermediaries. Deregulation has turned, in some cases, into little or no regulation, a worrisome situation in the case of an industry which has an important fiduciary responsibility. It is clear now (see below) that important rules regulating the health of the banking sector have not been enforced by the central bank. For example, rules regarding bank reserve requirements, limiting lending to a single borrower, or limiting lending to shareholders (of the bank) were flaunted by many small private banks.

By 1997, banking had become a convenient way to obtain cheap credit, at the possible expense of both depositors attracted by high deposit rates and of the entire banking sector. On November 1, 1997, the first concrete action of the GOI after reaching an agreement with the IMF was to close 16 insolvent banks. Among those were three banks with Suharto's relatives as shareholders.[20] One was Bank Andromeda, a bank in which Bambang, the President's second son, was a principal shareholder. Another was Bank Jakarta, which counts Probosutedjo as a shareholder. Tutut's bank escaped liquidation.[21] In a very unusual step, Bambang and Probosutedjo filed a lawsuit against the Finance Minister. (They withdrew their action later at the considering the action in the "interest of Indonesia.") Bank Andromeda's special treatment is a good example of the kind of practices that went

[19] For details, see MacIntyre (1993, pp. 144-145).

[20] Mydans (November 11, 1997).

[21] *The Economist* (November 8, 1997).

on before the current crisis. The bank lent $75 million to Bambang himself and to two other shareholders, who used the money to inject capital into the Chandra Asri petrochemical project (see below), of which they own 75 percent. Bambang's only defense was that "90 percent of Indonesian banks had flaunted lending restrictions as well."[22]

In addition to the closing of insolvent banks, weak banks are required to present a financial plan to Bank Indonesia explaining how they will deal with their weak position. As it became clear that Bank Indonesia was serious about reforms, a spate of mergers and acquisition hit the sector. Numerous banks started merging or selling stakes to new partners—including foreign ones. The Bakrie group merged three of its banks and sold 20 percent of Bank Nusa to Maybank.[23] In early 1998, the Indonesian Banking Restructuring Agency (IBRA) was established to supervise banking restructuring. As of May 1998, 40 banks have been placed under IBRA's supervision—14 are state-owned (three of the largest state banks and 11 state-owned regional development banks).

The position of the CPCs regarding strict banking supervision can be summarized as follows. The foreign and SOE CPCs stand to gain from this policy but for different reasons. SOEs look favorably at stricter banking supervision because it affects mostly private banks and not state-owned banks. As long as the private banking sector is in transition, i.e., turmoil, the Indonesian government will continue to hold its deposits in state-owned banks. (The government transferred a large amount of its deposits in state pension funds in September 1997 in an attempt to dry up liquidity.) In the long term, however, a more efficient private banking sector will be more of a threat to state-owned banks than it is today. SOEs have little leverage on banking regulation (which is decided by the central bank and the President's key economic advisors).

The foreign sector also stands to benefit from a healthier banking system, because foreign banks can better compete on a level playing field, and foreign firms prefer to do business with efficient banks. The foreign sector doesn't have leverage on this issue, other than the help of the IMF.

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22 Thoenes (November 24, 1997, p. 14).

23 Thoenes, *loc. cit.*

In contrast, the two other CPCs—Sino-Indonesian conglomerates and Suharto and kin—stand to lose if Bank Indonesia continues to close insolvent banks and tighten supervision. Suharto's kin face more adversarial effects than the Sino-Indonesian conglomerates because they don't have the latter's "deep pockets." The public outburst of Bambang and Probosutedjo testifies to the real pain such a policy is bringing to Suharto's relatives. Both CPCs have had high leverage on this policy because of their close connections to the presidential palace. Historically, monetary policy had been the purview of the technocrats. In early 1998, under the pressure from the two domestic CPCs, President Suharto stopped consulting with them. The clearest sign of this dramatic change was the firing of the Central Bank governor, one week before his term came to an end, because he opposed the idea of a currency board proposed by President Suharto.

CPC-based analysis thus reveals that banking supervision is a policy that can only be implemented at a very high political cost. We said in an earlier report (Treverton, Levaux, Wolf) that if President Suharto wanted to implement the policy, it needed to "[expend] considerable political capital given the negative effects of the policy on both Sino-Indonesians and Suharto's relatives." In fact, the President did not have enough political capital to carry through the reform.

Table 5.1 summarizes the rankings of leverage and influence of each CPC (as of end of June 1997) with respect to strict banking supervision. Figure 5.1 graphically represents the situation.

Figure 5.1 Position of CPCs Regarding Strict Banking Oversight

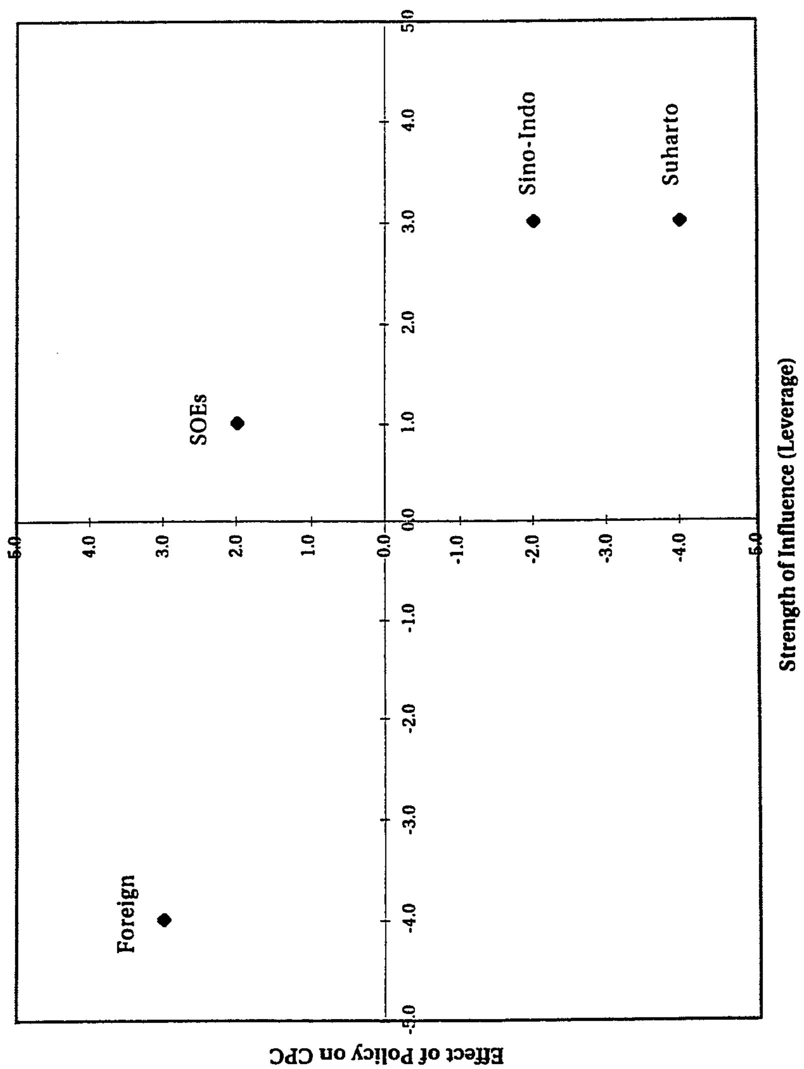

Table 5.1

Position of CPCs Regarding Strict Banking Supervision

POLICY REALM	MONETARY POLICY	
POLICY ISSUE	STRICT BANKING OVERSIGHT	
	Leverage of the CPC on Policy	Effect of Policy on the CPC
Sino-Indonesian	3.5	-3.5
SOEs	1.0	2.0
Suharto & Kin	4.5	-4.5
Foreign	-4.0	3.0

Fiscal Policy—SOE Reform

The cornerstone of fiscal policy in New Order Indonesia has been the balanced budget rule, which was instituted in 1967. Just as an open capital account is an expedient to impose self discipline on the central bank, a balanced budget rule forces policymakers to face the reality of matching expenditures to revenues, and helps them resist calls for additional government spending. In strictly economic terms, the rule is an accounting trick obligating expenditures to be balanced with domestic revenue plus aid and international borrowing. Under this system, aid and international borrowing are considered as revenue. This fundamental policy has never been seriously challenged. To deal with the current fiscal crisis, the government has had to increase revenue from sources other than international aid. In order to remain eligible for IMF financing, the government will need to sharply reduce expenditures so as to maintain an acceptable deficit (which has been set in the April agreement with the IMF at 3 percent). One way to achieve this in the short term is through the privatization of state-owned enterprises. (The other method is to cut subsidies on food and energy products, which sparked the riots that led to President Suharto's resignation and have been partly reinstated.)

In December 1986, following the abrupt drop in oil revenue, President Suharto called for an assessment of the financial soundness of every SOE and requested that a program be developed for their restructuring, including the possibility of selective

privatization.[24] As a result, SOEs have been constantly evaluated (according to a combined measure of profitability, liquidity and solvency) and categorized by level of soundness (from very sound to not sound). The restructuring plan for SOEs (issued in 1989) called for 52 public share issues, 15 changes in legal status (*perum* to *persero*), four cases of outsourcing through management contracts, 17 mergers, 16 joint ventures, and three liquidations.[25] Between 1988 and 1995, the Indonesian government carried out 15 partial privatizations, instead of the 52 planned, raising a total of US$ 4 billion.[26] Between 1995 and May 1997, only four partial share offerings have taken place.[27] No information could be found on the other reform objectives (mergers, outsourcing, etc.). In 1996, the President appointed a new team to oversee the stalled privatization process.[28] The team has been effectively dismantled, and President Habibie will probably set up a new team.

There are two factors that explain the slow pace of Indonesia's SOE reform and/or privatization: bureaucratic resistance and implementation problems (how to sell them and to whom). Both factors have been discussed in the section on SOEs. To recall, one of the most important decisions taken under the IMF-sponsored reform package of October was to shift control of the SOEs from line ministries to the Ministry of Finance. This should reduce bureaucratic resistance and allow for greater governmental autonomy in deciding which SOEs should be privatized and under what schedule. The implementation problem, however, is still significant.[29]

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[24]The fall in tax revenues from the oil sector forced the government to take austerity measures. In the period between 1983/84 and 1986/87 alone, government capital injection decreased by an annual (geometric) average of 53.6 percent, from Rp. 592 bn to Rp. 91 bn. (Hill, 1987, p. 21 and Pangestu and Habir, 1989, p. 232.)

[25] Mardjana (1992, p. 201).

[26] Bouton and Sumlinski (1997, Table 2.2).

[27]There were three initial public offerings (IPOs) in 1995: Tambang Timah (tin), Indosat (long-distance telephone) and Telekomunicasi Indonesia (Telkom, telephone operator); and two offerings in 1996: Bank Negara Indonesia (BNI) and a second offering for Telkom.

[28]The team was appointed by President Suharto in July 1996 and included such political heavyweight as the Finance Minister, Mar'ie Muhammad, Bank Indonesia governor, Soesradjad Djiwandono, and the perennial government economic advisor, Widjojo Nitisastro. See S.N. Vasuki, "Indonesia, New Team To Push Privatization," *Business Times*, Singapore, electronic version, July 13, 1997. By April 1998, all three were out of the decisionmaking circle.

[29]Since this report is concerned with the role of CPCs in policy, this section only addresses the issue of CPCs' position with respect to privatization. The issue of whether investors (part of a CPC or not) have the money and/or the confidence necessary to purchase state-owned assets on a large scale is not addressed here.

The implementation issue (how to sell state assets and to whom) remains an important obstacle.[30] As to how to sell, efficient financial markets are required to carry out multi-billion dollar transactions. The Jakarta Stock Exchange (JSX) was privatized in 1991 (effective June 1992) in order to meet growing demand for a modern, functioning stock market. Since then, it has grown significantly in sophistication and market capitalization. Furthermore, foreign brokerage firms can now assist in the process, when part of the offering takes place abroad. The 1995 IPO for Telkom, which raised US$ 3 billion had four local and four global (foreign) underwriters to float 25 percent of the company. This offering alone represented 16 percent of the JSX. Since 1996, however, foreign brokers could no longer secure any underwriting because of the "special deals" they would need to make in order to be allowed to act as underwriters. In several privatization efforts, foreign brokers made allegations of misconduct on the part of domestic brokers.[31] In the words of a member of the Indonesian financial community about a privatization in 1996: "technically [it] wasn't a privatization at all," it was a transfer of public resources to well-connected Indonesians.[32]

Close supervision by the IMF and international investors of the reform package might help to get rid of such egregious corruption. Even free of egregious corruption, the problem of who the buyer would end up being is political dynamite.[33] It remains politically impossible to raise the share of any of the potential buyers—Sino-Indonesians, Suharto's relatives, or foreign firms—in companies that need to be privatized, and no other source of capital exists. Given the need for supplementary government revenue, Habibie's Administration will need to carry out *some* privatization. Perhaps foreigners will be more acceptable now than they have been in the past, given the bad press Sino-Indonesians and Suharto's kin have received.

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[30] For an excellent review of the development of the financial sector in Indonesia, see Dickie and Layman (1988, pp. 28-73). The chapter on the development of the equity market is also excellent (op. cit., pp. 167-215).

[31] See on this Solomon (1997, pp. 54-55). The 1995 offering of 25 percent of Telkom was supposed to float the expected $3 bn with the following split: 12.5% abroad, 10% domestically, and 2.5% undecided. The IPO ran into trouble and the government had to slash the number of shares offered (down to 60%) to salvage the deal.

[32] (Solomon, 1997, p. 54).

[33] This situation is not new. Robison (1986, p. 213) already cites Minister Sadli (1970) and Minister of Industry Soehoed (1982) who both stress the "inadequate capabilities of national private savings" and the difficulty to find buyers for SOEs.

As of the end of June 1997, the position of CPCs regarding SOE privatization reveals that, expectedly, SOEs are the staunchest opponents of privatization. In the meantime, the transfer of regulation authority over them to the Finance Ministry has greatly deflected the SOEs' ability to oppose privatization efforts. Both Suharto's kin and the foreign sector would be positively affected by an increased pace of privatization. However, again, speaking as of June 1997, the kin have had more leverage (due to their presidential connections). They looked positively at acquiring state assets (at preferential prices) since it was the fastest way for them to expand their business empires. As of late, given the popular resentment against them, they may not be in the market anymore. For the foreign sector as well, acquisition of SOE assets is a good way to get a foothold or expand their business in Indonesia; yet, economic nationalism in the political discourse is still very much alive, and senior policymakers do not want to rely too much on foreign capital.

Sino-Indonesians have very mixed feelings about privatization. On the one hand, from a business perspective, they are keenly interested in privatization, but from a political standpoint, they are reluctant to acquire SOE assets as they fear a political backlash against their increased control over national production. Sino-Indonesian have more diversification and growth strategies available (other than acquisition of existing companies) than conglomerates controlled by Suharto's kin or foreign firms. On balance, they seem to prefer a slower privatization process during which their conglomerates could more easily "digest" the state assets they would purchase, without popular uproar.

The analysis reveals thus that policies to ramp up the privatization process is a policy that can be implemented (assuming enough investor confidence), but a big-bang approach to privatization is not acceptable politically. The process is likely to slow down as soon as the Indonesian economy returns to prosperity. Only accumulation of *pribumi* capital will make privatization on a large scale a viable policy option.

Looking into the future, one possibility would be to sell plantations to foreigners. It would be an attractive policy for three reasons. One, plantations require little inputs other than labor and could start operating before the Indonesian economy gets back on track. Two, President Habibie would probably look favorably at keeping manufacturing capabilities under state control. Three, in the current political climate in Indonesia, foreigners are better candidates than Sino-Indonesians or Suharto's kin to

purchase state assets. In any event, the realities of Indonesia's tense ethnic and social tensions coupled with remaining uncertainty about Habibie's future as President, will keep this effort from turning into a "big bang" privatization process.

Table 5.2 summarizes the rankings of leverage and influence of each CPC (as of end of June 1997) with respect to SOE privatization. Figure 5.2 graphically represents the situation.

Table 5.2

Position of CPCs Regarding SOE Privatization

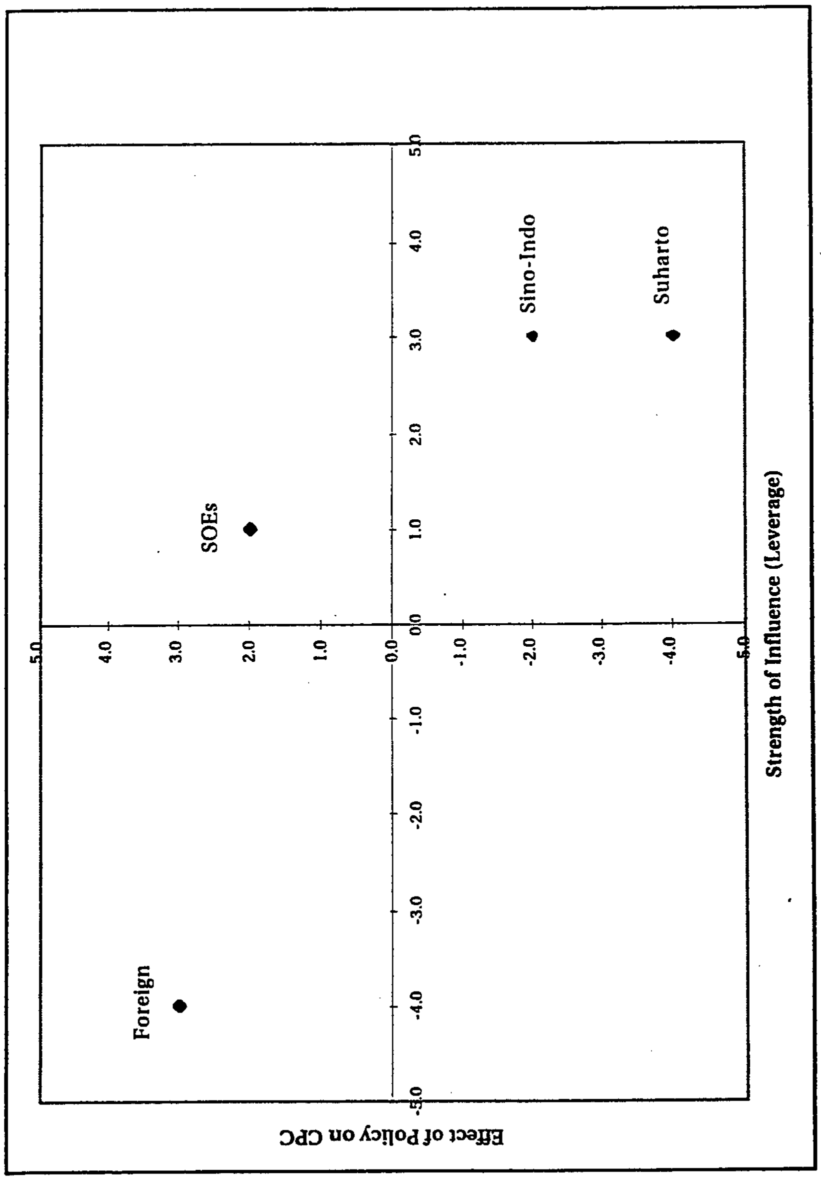
POLICY REALM	FISCAL POLICY	
POLICY ISSUE	SOE PRIVATIZATION	
	Leverage of the CPC on Policy	Effect of Policy on the CPC
Sino-Indonesian	0.0	2.0
SOEs	3.0	-4.0
Suharto & Kin	4.0	4.0
Foreign	2.0	4.0

Trade Deregulation—Deepening of Trade Liberalization

Although Indonesia has already come a long way from the import license/export requirements system in place until 1986, it still has a substantial amount of trade subjected to high tariffs or to NTBs. Since May 1986 (with the so-called BAPEKSTA scheme of import duty and VAT drawbacks), the Indonesian government has unveiled each year a new list of tariff and NTB reductions.[34] In November 1994, the Indonesian government joined the other APEC member countries to begin forming an APEC free trade area set for 2020.

[34]In 1985, the government signaled its commitment to open trade by outsourcing its customs operations (administered by a private Swiss-based company, Société Générale de Surveillance) and bypassing the blatantly corrupt customs bureaucracy. However, at the end of 1996, as a stark warning of the Suharto's Administration growing disregard by for international considerations, the Indonesian government rescinded the mandate of the Swiss operators.

Figure 5.2 Position of CPCs Regarding SOE Privatization



In May 1995, the government joined other ASEAN countries in AFTA (ASEAN Free Trade Area) and unveiled a comprehensive package of tariff reduction covering two-thirds of all traded goods and committing Indonesia to reduce most tariffs to under 5 percent by 2003. Hence, at the macro-level, it seems that the Indonesian government has been committed to trade liberalization.

Table 5.3 indicates how Indonesia's economy has been steadily opening up to international trade, with an increased reliance on non-oil —in particular manufacturing—exports after 1986 and an increased import penetration of goods other than oil. This has made trade liberalization an important item on Indonesia's policy agenda, with tariff reductions and reductions of non-tariff barriers NTB coverage becoming the key aims of this liberalization.

Table 5.3

Indicators of Trade and Industry, 1980-1992

	Output Growth	Manufactured Exports		Export Shares (%)		Import Penetration	Coverage of NTBs
	(non-oil, %)	Total ($ million, nominal)	Growth (% real)	Non-oil	Manufactures	(%)	(%)
1980	19.7	501		10.3	2.3	15.1	
1981	10.1	673	21.2	6.3	3.0	16.2	
1982	0.9	809	17.2	5.2	3.6	17.5	
1983	2.7	1,373	67.8	7.4	6.6	18.0	
1984	13.0	1,839	31.1	8.3	10.1	15.8	
1985	12.5	2,044	10.7	7.8	13.1	12.0	
1986	11.1	2,639	34.0	9.2	19.3	13.6	68
1987	11.4	3,895	43.8	13.1	25.0	17.3	58
1988	12.8	5,476	35.6	15.6	29.8	16.7	45
1989	11.6	7,018	22.1	16.4	32.0	18.5	38
1990	13.0	9,041	24.2	15.9	35.4	21.7	33
1991	10.9	11,816	29.9	18.3	40.8	23.6	32
1992	10.7	16,061	35.0	21.0	47.5	23.0	31

Source: Aswicahyono, et al., (1996, Table 1, p. 344).

Notes: Output Growth is real growth of non-oil manufacturing value added; Non-Oil Export Shares refer to non oil exports as a percentage of non-oil GDP; similarly, Manufactures Export Shares refer to manufactures as a share of total merchandise exports; Import Penetration refers to non-oil imports as a percentage of non-oil GDP; and NTB coverage refers to non-oil manufacturing output covered by non-tariff barriers.

After the Uruguay round in 1986, tariffs on several basic industries were drastically cut. For example, textile and apparel tariff rates were cut respectively by 22.5 and

16 percent, down to 26.3 and 36.3 percent.[35] Although the progress is substantial (fairly low average tariff levels) and ongoing (annual packages), the tariff system remains overly complex with over 9,200 tariff categories (a "made-to-measure code" in the words of the World Bank.[36]

The situation with respect to non-tariff barriers is similar. NTBs exist mainly in the form of import licensing (but also of export restrictions). Import licensing can deter trade even in the presence of low tariffs. For example, in the steel industry before 1986, tariff rates were at 5 percent for basic steel products, but did not really matter since PT Krakatau Steel (SOE) was the sole accredited importer for several key product categories.[37] Major strides have been made to reduce NTBs since 1985-1986. The share of domestic production of tradable products subject to import licensing has decreased steadily from 41 percent in 1986 to 22 percent in 1992. The opening to imports has been greatest in manufacturing where NTB coverage decreased from 68 percent in 1986 to 31 percent in 1992 (see Table 5.3). Similarly, in value, the coverage of NTBs has steadily declined from 43 percent in 1986 to 13 percent in 1992. In terms of the number of products covered by NTBs, the trend has been downward, from 1,700 CCCN items in 1985 to 800 in 1989 and 464 in July 1992 (PAKJUL).[38]

Despite these important steps in the direction of freer trade, some sectors remain stubbornly protected, and tariffs or NTBs directly targeted at particular goods still exist. In most cases, the protection can be linked quite directly to powerful domestic interests, to either SOEs or private conglomerates (Sino-Indonesian and/or Suharto and kin). In some cases, firms requesting protection belong to just one CPC; sometimes, it is a team of firms from several CPCs asking for protection; and the most interesting case is that of firms from different CPCs fighting for or against the protective measure. Four examples stand out as particularly illustrative: the national car project, the Chandra Asri petrochemical complex, agricultural imports, and export restrictions.

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[35] Lewis (1996, Table 6, p. 20).

[36] World Bank (1994, p. 66).

[37] Chapman (1992, p. 74).

[38] No data more recent than 1992 were found, but it is very unlikely that the trend has reversed. See Wymenga (1991, throughout) and World Bank (1994, pp. 64-66). CCCN: Customs Cooperation Council Nomenclature.

The Indonesian motor vehicle industry is protected by tariffs and surcharges of 200 percent for cars and 150 percent for motorcycles. Such protection helped a Sino-Indonesian automotive group (Astra) become the largest conglomerate in Indonesia at one point. The automobile market is controlled by Japanese manufacturers, that have their cars distributed through dealerships owned by Sino-Indonesian concerns (like Astra). In order to foster domestic manufacturing, heavy tariffs are applied to imported vehicles. Local companies, like Astra, have steadily increased the local content of the cars assembled in Indonesia; yet, they claim that Indonesia's manufacturing capabilities are still too limited, and that local content cannot be increased beyond 60 percent in the coming years.

Taking Malaysia's Proton car as an example, President Suharto wanted for some time to have a "national" car—one entirely built in Indonesia and not simply assembled from knock-down kits. At least two of his sons seemed well placed to win the contract. In collaboration with Korea's Hyundai Corporation, Bimantara Cakra Nusa (part of the Bimantara Citra group, owned by Bambang) proposed to produce a derivative of the already available 1,500 cc Cakra.[39] In collaboration with Korea's Kia, Suharto's youngest son, Tommy established PT Timor Putra Nasional. Given Tommy's' lack of experience in car manufacturing, most insiders expected Bambang and Hyundai to win over Tommy and Kia. Yet in February 1996, a presidential decree gave Tommy's team a three-year contract to build the car.[40] The car was exempted from import duties and taxes for three years, and retailed at Rp. 25 million—half the price of existing sedans.[41] Even more ironic, in June 1996, another presidential decree allowed Tommy's team to import the first 45,000 "national" cars from South Korea (thereby defeating the very purpose of the "national" car project).[42]

Despite its price advantage, however, the car has not sold well, and government agencies have been directed to buy the car in order to boost sales. The national car project is such an egregious violation of trade regulations that both the Japanese and European governments have filed an official protest at the WTO. The preferential

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[39] *Singapore Business Times*, Aug. 22, electronic copy.

[40] It appears that it is out of a desire to help Tommy increase the scale and scope of his activities that President Suharto chose his team over his brother's.

[41] Sinclair (1996).

[42] McBeth (June 1996).

treatment given to Tommy also goes directly against the interests of powerful Sino-Indonesian conglomerates, including Astra, which is the distributor of Toyota cars and Isuzu trucks in Indonesia. Despite alienating such domestic and international heavy-weights, President Suharto stood by his son and refused to diffuse the tension.[43] Only with the crisis of summer/fall 1997 and the ensuing IMF package did the Indonesian government accede to the minimal request from the international community—namely, to agree to abide with the upcoming WTO ruling, which almost certainly will find the preferential treatment contrary to Indonesia's international obligations.

A second illustration of targeted protection is Chandra Asri, a $1.6 billion petrochemical complex in West Java. Whereas two of Suharto kin, allied with foreign companies, competed for the national car project, in the case of Chandra Asri, the competing groups were two Sino-Indonesian tycoons (Bob Hasan and Prajogo Pangestu), a Japanese trading company (Marubeni Corporation) and President Suharto's middle son, Bambang.[44] To support the project, the government reversed a long-term trend toward lower tariffs by imposing higher tariffs on propylene and ethylene, from 5 to 25 percent despite an explicit commitment by the government in 1994 not to raise tariffs on new industrial ventures.

Despite forceful opposition by the international community, the Indonesian government would not accede to the global demands to lower tariff rates as initially agreed upon. In this case as well, it is only with the crisis of summer/fall 1997 and the ensuing IMF package that the Indonesian government agreed to reduce tariff rates on these chemicals.[45]

The third outstanding area of trade friction is agricultural imports (rice, sugar, wheat, and soybeans). These imports are administered by the National Logistics Agency, BULOG (an SOE), which is the sole agent for the importation of these commodities

[43]It is worth noting, however, that the Salim group, which owns 7.37 percent of Astra has been subsequently chosen (through Salim's Indomobil) to participate in the assembly of knocked-down kits imported from Korea (McBeth and Solomon, February 1997, p. 54).

[44] McBeth (February 1996, p. 53).

[45]Tariffs on ethylene, propylene, styrene, polyethylene, polypropylene, and polystyrenes range from 25 to 40 percent. In 1998, the highest tariff rates will be reduced by 5 percent and will be reduced to 20 percent in 2000 and 10 percent in 2003. For details, see *Communications from the U.S. Embassy in Jakarta*, addressed to Department of the Treasury and Department of Commerce, November, 3, 1997.

and their allocation to designated monopolies. In the case of wheat, for example, the country's four mills are owned by the largest Sino-Indonesian conglomerate, the Salim group.[46] Here again, it is only with the crisis of summer/fall 1997 that the Indonesian government acceded (in the IMF package) to the minimal request from the international community—namely, to revoke BULOG's import monopolies. Yet, concerns about the price of staple food have so far spared sugar and rice, for which BULOG retains the responsibility of stabilizing their supply and price.

Finally, export restrictions (under the form of a ban or export tax) are also used to protect certain sectors. For example, very high export taxes ($250-$1,000 per cubic meter) were applied to sawn timber in the hopes of developing downstream industries. This did not materialize as fully as anticipated, but the plywood industry (largely dominated by Bob Hasan, a prominent Sino-Indonesian, close friend of President Suharto and chairman of Apkindo, the now dismantled plywood association) continued to benefit from this protection with low-priced inputs. Indeed, Rodgers showed in her Ph.D. dissertation that "Indonesia's tropical log export ban is the most important policy behind its status as the world's largest plywood exporter."[47] Despite calls from the World Bank and the IMF, the Indonesian government refused to eliminate export restrictions. Under the second IMF agreement (January 1998), Apkindo was officially disbanded, but Bob Hasan tried to revamp the system under another name. It is another example of a policy in which the power of the private actor exceeded that of the President himself (who had signed the agreement with the IMF).

In sum, Indonesia's trade deregulation is characterized by a dual evolution of continued liberalization and of—sometimes new—targeted protection. Hence, the policy question is whether particular CPCs support trade liberalization across the board or whether a selective approach is preferred. SOEs are generally against trade opening as it undermines their control of the economy. Sino-Indonesian conglomerates and Suharto's kin are in favor of trade liberalization, as a principle; but they still ask for selective protection for their own projects—like the national car project or

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[46] See World Bank (1994, pp. 64-72 passim), Bird (1996, pp. 3-4), Manning and Jayasuriya (1996, pp. 18-25), and McLeod (1996, pp. 6-79).

[47] Rodgers (1993, p. ii. See also chapter 5, section 5: Results).

the Chandra Asri project. Finally, foreign firms are in favor of freer trade and more transparency in trade regulations.

In terms of leverage, it is evident that the CPC with the least leverage, in normal times, is the foreign sector. Yet, in times of crisis, pressure from foreign governments, relayed through the IMF can sometimes yield substantial changes in policy that would not otherwise take place. These changes, by leveling the playing field, are to the advantage of competitive foreign firms in the short term and to Indonesian consumers in the long run.

Table 5.4 summarizes the rankings of leverage and influence of each CPC (as of end of June 1997) with respect to trade deregulation and liberalization. Figure 5.3 graphically represents the situation.

Table 5.4

Position of CPCs Regarding Trade Liberalization

POLICY REALM	TRADE POLICY	
POLICY ISSUE	DEEPENING OF TRADE LIBERALIZATION	
	Leverage of the CPC on Policy	Effect of Policy on the CPC
Sino-Indonesian	4.5	-2.0
SOEs	2.0	-4.0
Suharto & Kin	4.5	-2.0
Foreign	-2.0	4.5

Investment Policy—Foreign Investment

Key to sustaining the high rate of economic growth is the need to mobilize domestic resources—both public and private—to finance the level of investment required for growth. From the early 1970s through 1986, Indonesia relied heavily on the proceeds of oil exports to finance its development and meet its demographic challenge (labor absorption). Investment was channeled to sectors of the economy deemed essential to Indonesia's development—especially in capital intensive manufacturing. This channeling of investment funds was (and still is) managed by BKPM (the Capital Investment Coordinating Board, which approves all investment other that in oil and gas and financial services). By the end of the 1970s, BKPM had drawn up an exten-

sive and complex list of sectors for priority investment and had determined which sectors were opened to foreign investment and, if so, with what maximum equity.

With the fall in oil revenue in the late 1980s, however, non-oil industries had to take the slack—with the difference financed through international debt. Fostering private (domestic and foreign) investment was seen as the only way to sustain the required growth rate. In 1986, BKPM officially recognized the benefits of foreign investment and adopted the first in a series of reform packages. Several packages were adopted in the subsequent years—all supporting increased liberalization of investment procedures and the opening up of the economy to private Indonesian and/or foreign investors.

Although there is no clear supporting statistical analysis, a cursory look at the investment policies of New Order Indonesia reveals an inverse relationship between economic growth and the deregulation of foreign investment. When the economy does well and foreign investment is high, the deregulation progress tends to slow down; and conversely, when the economy hits bottom, Indonesia puts together attractive deregulation packages to attract foreign investment.

For example, despite an important deregulation package in October 1993, foreign investors did not submit more investment applications. In light of this failure to attract foreign investment, the government implemented the most sweeping reform package yet in June 1994—providing almost equal treatment between domestic and foreign investment in sectors open to foreign investment; relaxing regulatory controls of foreign investment; and opening large sectors to foreign investment such as telecommunications, power generation and construction of toll roads and airports.[48]

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[48] Hobohm (1995, pp. 10-11).

Figure 5.3 Position of CPCs Regarding Trade Liberalization

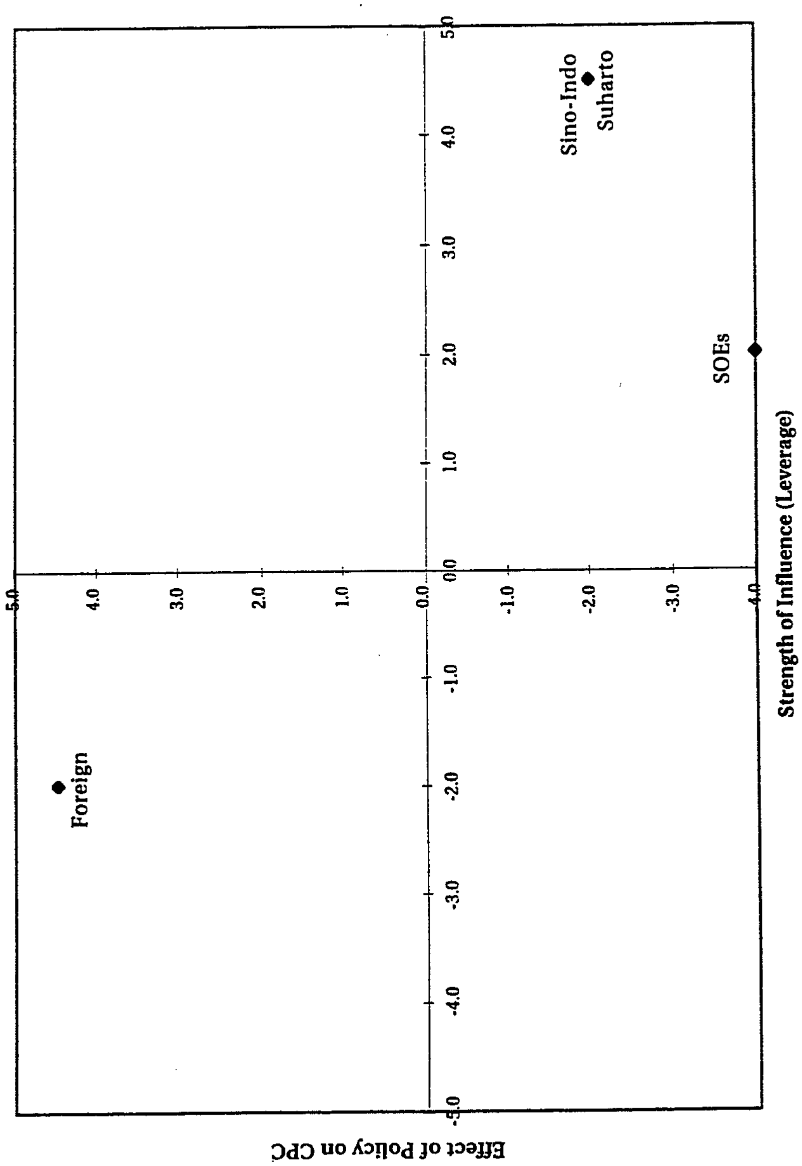

Table 5.4 provides an overview of the sources of investment in Indonesia's five-year development plans.[49] The data make clear that, up to the mid 1980s, public sector investment represented a substantial portion of overall investment. The government still projected public funds to contribute to 39.4 percent of total domestic investment for Repelita V (1989/94). Yet, actual figures came down to only 27.2 percent. As a result, in Repelita VI, the government is planning a much more modest 26.6 percent of domestic investment to be carried out by the public sector; while the private sector is projected to increase its share of domestic investment to 73.4 percent. Forty-five percent of domestic investment projects (in 1994) are aimed at supplying the domestic market.[50] As a consequence of the 1997/98 crisis, all these projections are wrong.

Table 5.4

Sources of Investment Funds—Public/Private

Repelita	Domestic		Domestic			Foreign
	Share Domestic Investment		Share Total Investment			
	Public	Private	Public	Private	Total	
II ('74-79)	51.3	48.7	36.8	34.9	71.7	28.3
III ('79-84)	37.3	62.7	29.5	49.5	79.0	21.0
IV ('84-89)	41.2	58.8	33.3	47.6	80.9	19.1
V ('89-94, P)	39.4	60.6	37.0	56.9	93.9	6.1
V ('89-94, A)	27.2	72.8	25.0	67.0	92.0	8.0
VI ('94-99, P)	26.6	73.4	25.1	69.4	94.5	5.5

Key: Shaded area are projections (P), (A) means actual figures.
Source: Compiled from Booth (1989, Table 3, p. 7; and 1994, Table 4, p. 10), Hill (1996, Table 6.6, p. 108).
Note: Year is April 1 through March 31.

Although private investment is indeed replacing public investment, domestic investment is not sufficient to meet the five-year plan's growth objectives. Foreign investment is also needed to support industrial development, and also to hold down the current account deficit. Although the share of foreign investment (relative to

[49]The International Finance Corporation provides slightly different numbers than these provided here (by the Indonesian government). According to the IFC, private investment has averaged 61.6 and 65.5 percent respectively in 1980-1989 and 1990-1995. As a share of GDP, private investment has averaged 15.7 and 18.2 percent of GDP respectively in 1980-1989 and 1990-1995. For the same periods, public investment represented 9.7 and 9.6 percent respectively (Bouton and Sumlinski, Table A2.4).

[50] Hobohm (1995, p. 11).

domestic private investment) has been falling steadily, foreign investment remains necessary for Indonesia not only in quantity, but also in quality (given the know-how that foreign firms bring with them). Just as a small party in a government coalition can have disproportionate influence, foreign investors command influence disproportionate to their size and are keenly wooed. Furthermore, the figure of foreign investment approvals, published monthly now, is a closely watched indicator of international confidence in the Indonesian economy. In this sense, the role of foreign investors is very similar to that of foreign merchants in medieval trading fairs.

Despite numerous investment deregulation packages and the positive role played by BKPM, investment controls remain extremely complex and decentralized. For example, changes related to the opening of more sectors to foreign investment involves 14 government departments.[51] Investment deregulation should facilitate both domestic and foreign private investment. In this spirit, allowing private firms to set up operations in export processing zones (a privilege reserved to SOEs until 1996) is a step in the right direction. The 1997 IMF package includes several reform measures aimed at giving further access to these export processing zones.

In terms of savings on transaction costs, the Sino-Indonesians, Suharto and kin, and foreign CPCs favor investment reform and a more transparent approval process. Yet, domestic CPCs are still keen on keeping the investment process non-transparent, since it allows them to extract economic rent more easily than foreign investors, who do not know all the ropes of the trade. More investment deregulation means more competition, which is against the interests of established rent-seekers. SOEs are presumably opposed to investment deregulation, as reform would ultimately decrease the power of the bureaucracy. No evidence, however, was found suggesting that the SOEs have faced an easier investment approval process than their private domestic counterparts. Foreign firms strongly favor further deregulation and unconditional national treatment.

Table 5.5 summarizes the rankings of leverage and influence of each CPC (as of end of June 1997) with respect to trade deregulation and liberalization. Figure 5.3 graphically represents the situation.

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[51] Indoexchange (1997, p. 3).

Table 5.5

Position of CPCs Regarding Investment Deregulation

POLICY REALM	INVESTMENT POLICY	
POLICY ISSUE	EQUAL TREATMENT OF FOREIGN INVESTORS	
	Leverage of the CPC on Policy	Effect of Policy on the CPC
Sino-Indonesian	3.0	-3.0
SOEs	4.5	-4.0
Suharto & Kin	4.0	-4.0
Foreign	-2.0	4.5

POLICY MATRIX AND CONCLUSIONS

Hereafter follows the policy matrix (Table 5.6) articulating the major policies identified by, and the position of each CPC with respect to them. This matrix incorporates the conclusions presented at the end of the discussion of each policy choice. Each cell: (1) shows the position of a given CPC with respect to a given policy, (2) identifies the channels of influence used to foster that position; (3) assesses the CPC's effectiveness in achieving its goals; and (4) assesses the dynamics of influence (increasing or receding) of the CPC on that particular policy.

The policy matrix provides, in a nutshell, a description of how the unbridled political activities of CPCs have contributed to the collapse of Suharto Inc. In particular, the political activities of powerful domestic CPCs to obtain preferential and "selective" regulation have created an environment in which financial rewards were tied, not to sound business decision, but to successful political activities. Yet, as discussed in both the theoretical and historical chapters, this increased political activities of CPCs is a normal phenomenon that has to be expected when the economy experiences high growth and transitions to a market economy. The real culprit of the crisis, however, it not the CPCs, but the underdevelopment and inadequacy of nonmarket institutions in arbitrating demands by market actors (CPCs).

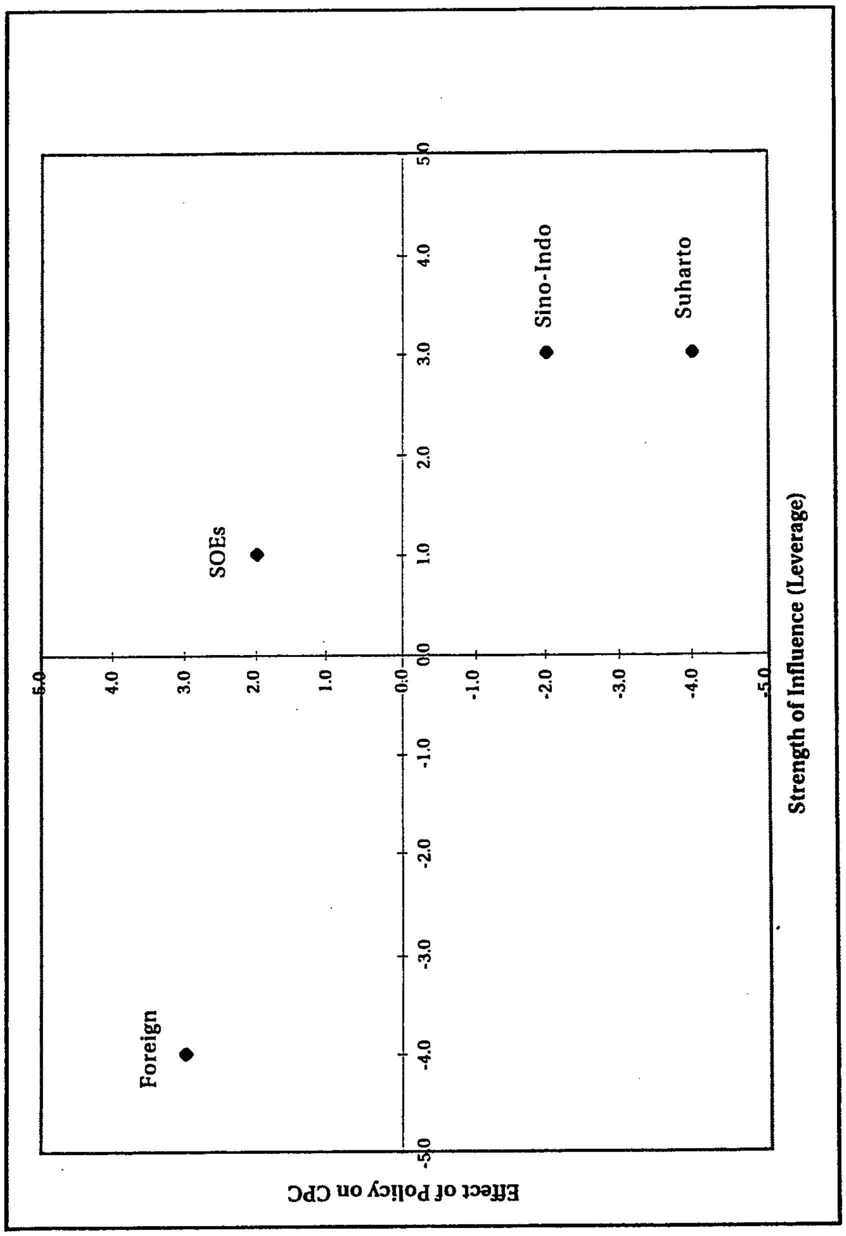

Figure 5.4 Position of CPCs Regarding Investment Deregulation

Table 5.6

POLICY MATRIX

		Macroeconomic Policy			
		Monetary--Banking Supervision	Fiscal--SOE Reform	Trade Liberalization	Investment Reform
Sino-Indonesian	Position	**Loose supervision**	Selective privatization	Selective liberalization	Simplify system
	Channel of influence	President & Executive	President & private partners	President & private partners	President & Executive
	Effectiveness	Limited	High	High	Limited
	Dynamics	Increasing	Increasing	Increasing	Stable
SOE	Position	Strict supervision	**Against privatization**	Keep protection	Keep complex system
	Channel of influence	Executive	Executive & private partners	Executive & private partners	Executive & BKPM
	Effectiveness	Limited	High	Limited	Limited
	Dynamics	Receding	Stable	Stable	Receding
Suharto & Kin	Position	**Loose supervision**	Selective privatization	Selective liberalization	Simplify system
	Channel of influence	President	President & private partners	President & private partners	President
	Effectiveness	Limited	High	High	Limited
	Dynamics	Increasing	Increasing	Increasing	Stable
Foreign	Position	Strict supervision	**Selective privatization**	**Full-blown liberalization**	**Simplify system**
	Channel of influence	President or stop investing	President or stop investing	President or stop investing	President or stop investing
	Effectiveness	Limited	High	High	Limited
	Dynamics	Increasing	Increasing	Increasing	Increasing

NOTE: Bold items represent items of greatest priority

In this sense, it is indeed President Suharto's grip on power that caused his own demise. Historical analogies suggest that the crisis Indonesia is experiencing will result, in time, in a more open political system, with Parliament playing a greater role in doing the necessary political arbitrage. The analogies suggest also, however, that the process may be long, chaotic, and perhaps violent at times.

More formally, we can interpret the demise of President Suharto as the direct consequence of an ill-functioning quasi-market for political influence. Suharto family members and a few of the leading Sino-Indonesian business tycoons have literally hijacked this quasi-market in the 1990s, holding a complete monopoly on the quasi-market and keeping its doors closed to other CPCs. They required payments on any deal that they could facilitate. As a result, instead of having a healthy process of competition among pressure groups leading to more efficient policies—as suggested by Becker's model—the activities of Indonesian CPCs led to inefficient and ultimately destructive policies.

Both the policy matrix and Figures 5.1-5.4 clearly indicate that it was virtually impossible for President Suharto to implement the reform measures he had negotiated with the IMF. The Figures are particularly telling. The three domestic CPCs shared their opposition to trade liberalization and investment deregulation (Figures 5.3 and 5.4), while the Sino-Indonesians and Suharto's kin were opposed to banking oversight (Figure 5.1). The only policy that could gather CPC support was SOE privatization (assuming that SOEs' opposition could be overcome), but such policy option was (1) politically difficult given the problems associated with finding acceptable buyers (Sino-Indonesians, Suharto's kin and foreigners all rejected by Indonesians) and (2) not possible when the country was facing a severe liquidity problem and a run on its currency and its banks. In short, our analysis of CPCs' influence suggested that the measures could not be implemented by the ultimate guarantor of CPC power.

Yet, before Suharto's demise, we discounted the findings and thought that, although difficult to implement, the measures would be carried out given the sterling record of President Suharto and his team of economic advisors. If we had looked more thoroughly at the results of the CPC analysis, we would have arrived at a different—i.e., correct—conclusion. We were not thorough enough in our appreciation of the anal-

ysis and its results, which proved correct. CPC power and influence had become excessive during the 1986-1997 period. Only new leadership can implement the tough policy medication that Indonesia needs to take. Existing CPCs will be severely affected by the resulting reforms, but new groupings of business interests will form again and will, it is our hope, contribute to the adoption of more efficient policies.

Chapter Six

POLICY IMPLICATIONS AND FUTURE RESEARCH

POLICY IMPLICATIONS

It has been our contention throughout this study that the CPC framework allows scholars, policy analysts, and decisionmakers in government or business to view more clearly the political role of market actors (CPCs) in economic development, as well as the relationship between CPCs and nonmarket actors (governments writ large). Three aspects of the analysis allow to draw policy inferences, which tie in the analysis with its potential applications.

First, in Becker's model, the political activities of CPCs enhance efficiency—and, hence, economic growth—only if the quasi-market is characterized by zero transaction costs and well established property rights. Very low transaction costs can be best approximated through competition and free entry in the quasi-market. Clear establishment of property rights depends on the prevalence of the rule of law. To promote efficiency therefore, it behooves governments of emerging market economies, supported by lending agencies, NGOs, etc., to promote this competition. It requires an institutional framework that allows freedom of speech and assembly for business interests and that protects the property rights of parties to business transactions.

This is a departure from Becker's model since he argued that pressure groups are the most important actors in the quasi-market and nonmarket actors are mere transmitters of policy. We have shown that this is true only if the market is already characterized by competition and free entry. If not, then, either market and/or nonmarket actors have to establish the required institutions to promote a healthy quasi-market—i.e., competitive with free entry. The historical analogies have highlighted the process leading to such a situation.

Second, the historical analogies have underlined the need for the parallel development of market and nonmarket institutions. In emerging markets, like in developing Europe of medieval and mercantile ages, the risk of institutional slippage—i.e., monopolization of the quasi-market by CPCs, or non-provision of adequate institutions by market actors—is large due to the small number of players in policymaking. Both market and nonmarket are characterized by few actors. Their positive interplay is necessary for continued economic growth and institutional development. If and when the market experiences sustained growth over years if not decades, it is to be expected that the nonmarket would not able to adapt to new requirements as quickly as the market. Whereas the latter pursues one objective (some form of profit maximization), the former pursues multiple objectives (including the development of supporting institutional and material infrastructure).

As Douglass North emphasized, institutions are the codification of rules. Market actors in emerging markets often work in uncharted territories, without existing rules. They need rules to grow and will seek some form of collective action to spur the government to enact needed regulation or law (e.g., regarding trade liberalization in favor of exporters). However, given past experience and with support from lending institutions or others, governments can put in place a regulatory framework conducive to economic growth—such has been the path chosen by several NICs, with Taiwan at the forefront. North also emphasized that "institutions form the incentive structure of a society, and the political and economic institutions, in consequence, are the underlying determinants of economic performance."[1] The improvement of economic performance, therefore, is an obligation of both market and nonmarket actors, CPCs and governments.

Third, the application of the framework to Indonesia has underscored the role of CPCs in policymaking and the role of political entrepreneurs who lead CPCs. The history of Suharto's new Order can be roughly divided into three periods. From 1966-1974, the Sino-Indonesian conglomerates vied, against the military and the SOEs, for influence and for an increased share of government preferential treatment. After the start of the oil boom, from 1974-1986, the Sino-Indonesian CPC became monopolistic, yet was restrained in its greed because of the ethnic identity of its

[1] North (1994, p. 359).

members. Finally, after 1986, accelerating growth was generating increased rent-seeking activities by politically connected entrepreneurs—lured by the potential profits stemming from preferential treatment. What could have turned into a virtuous circle (more deregulation leading to more demands for deregulation by more CPCs) instead became a vicious circle. Indeed, concomitantly with deregulation and the ensuing growth, Suharto kin entered the quasi-market for influence. Especially after the death in 1994 of Suharto's wife, the kin monopolized the quasi-market. Contrary to Sino-Indonesian, their greed was not checked by ethnic concerns. The examples of the national car project or Chandra Asri provide ample anecdotal evidence for it. Positive rent-seeking activities had turned into the most egregious forms of rent-seeking; these would eventually cause Suharto's fall at a tremendous cost for Indonesia.

The crisis that has ravaged Indonesia since July 1997 provided the opportunity to test the CPC methodology. As the previous chapter underscored, analysis of CPC interests shows that it was virtually impossible for Suharto to deliver on his promises for reform to the IMF. As the IMF has since recognized, had it been aware of this situation, it would have suggested different policy responses to the crisis.[2]

What are thus the policy inferences that can be made based on these three aspects of the analysis? The United States has long placed the promotion of democracy and markets on top of its foreign policy agenda—whether through the Marshall Plan or through President Clinton's dual commitment to promote prosperity and democracy.[3] As Fareed Zakaria, the managing editor of Foreign Affairs underlined, however, there is a conceptual and fundamental difference between democracy and constitutional liberalism. Universal suffrage characterizes the former, and institutions supporting democracy and free markets—such as the rule of law, private property rights, and increasingly separated powers of free speech and assembly—characterize the latter.[4] Zakaria makes the point that it is easier to promote democracy (the litmus test being free elections) than to promote constitutional liberalism (which is much more nebulous and takes time to put in place).

2See Lane et al. (1999, especially chapter VIII on structural reforms, pp. 101-118).

3See for example the latest edition of the *National Security Strategy* (1998, pp. 27-35).

4Zakaria (1997, p. 27).

Echoing and reinforcing Zakaria's' remarks, two broad but key policy implications derive from the CPC analysis. First, a *healthy—i.e., competitive—quasi-market for political influence is a prerequisite for the development of market capitalism.* Multiple institutions are important in fostering economic development. CPCs are very important institutions in fostering market capitalism. They can be viewed as the NGOs of the private sector. International lending institutions and development agencies have placed much emphasis on the development of institutions on the supply side of the quasi-market for political influence. As much effort ought to be placed in monitoring and promoting the establishment and development of trade associations, professional organizations, and other types of business representation. Without such institutions, emerging markets are too frail to survive the profound economic and social shocks that characterize the developmental process.[5]

Second, a *healthy—i.e., competitive—quasi-market for political influence is a prerequisite for the development of democracy and parliamentary life.* On the supply side, it requires the institutions long called for by institutional economists, such as functioning court system, enforceable bankruptcy laws, or efficient customs operations. On the demand side, it requires a healthy demand side of the quasi-market, composed of multiple and competing CPCs. Competition among CPCs allows for compromises that are consistent with the prevailing local market conditions. Rather than imposing pre-made institutional mechanisms, it is preferable to let the local quasi-market for political influence decide policy trade-offs and priorities. CPCs have historically contributed greatly to the emergence of Parliament and courts of law as checks to the power of the Executive. The same is true in today's emerging markets.

More pointedly, the CPC framework can be used by national and international aid and lending institutions, the intelligence community, and multinationals. These three constituencies need to assess the political stability and the sustainability of economic development of various emerging market economies. Neither assessment can be done adequately without evaluating the role of private sector actors in the policymaking process.

5See on this point Hausmann (1997).

The post hoc admissions by both the IMF and the World Bank that they had erred at the beginning of the Asian financial crisis due to a poor assessment of "local conditions" highlights the need for these institutions to have a good understanding of local policymaking *before* the onset of crises. As mentioned already, had the IMF used CPC analysis, it would have clearly seen the enormous difficulty President Suharto faced in trying to implement the package of reform measures of October 1997 (and subsequent packages). The package of reform measures could have been more targeted at immediate problems—e.g., stabilization of the currency. In seeking to eliminate monopolies and completely reform the banking system, the IMF was effectively demolishing the foundations of the Indonesian economy and suppressing the sources of CPC revenues. It was doomed to generate strong political opposition from certain CPCs and paralyze Suharto's regime at a time when action by, and confidence in, his regime were most important.

Although the unintended consequence of IMF pressure may have been positive (the peaceful downfall of a long-time autocrat and, in the long term, the possibility for Indonesia to establish the required political institutions for its economy to further develop), the economic and social cost is such that it may require years for Indonesia to return to the level of growth and prosperity it enjoyed in June 1997. The role of the policy analyst is to provide policymakers with information and analysis that allow them to make decisions with an understanding of their likely consequences. It is doubtful that the IMF fully understood what its plan for reform of October 1997 entailed.

The World Bank for its part, no later than Spring 1997, was vaunting the merits of Indonesia's macroeconomic stability. Although it deplored the increased prevalence of corruption, the Bank did not ring the alarm bell. The CPC analysis would have offered a systematic and integrated view of how deep Indonesia was sinking into paralysis, because of a small group of well-connected tycoons. The best macroeconomic policy could not save Indonesia in the face of a massive loss of confidence by domestic investors. Simple figures like those shown in the previous chapter would have convinced the Bank that, for example, reform of the banking sector could not happen without a hefty dose of political arms-wrestling by the Bank. Instead, the Bank had ongoing programs to reform the financial sector, but without a clear sense of the situation, nor of the urgency of reform.

As a consequence of the Asian crisis, the Bank has acknowledged that it needs to take a more comprehensive approach to program and country monitoring. In its annual report of development effectiveness, the Bank drew two conclusions from the Asian financial crisis:

> First, good macroeconomic fundamentals are necessary but insufficient for stable and sustainable growth. In today's global economy, sound institutions especially in the financial and social sectors, are essential to economic and social stability. Second, projects are no longer the appropriate vehicles for development assistance unless they are connected to balanced country assistance strategies focused on structural reform and capacity development.[6]

Both these conclusions are directly implied by this analysis. Going further than the Bank, however, we suggest that the Bank needs to pay attention and support the development of institutions that are conducive to a competitive quasi-market. Only institutions enhancing competition in the quasi-market (e.g., trade associations, chambers of commerce, bankruptcy laws, etc.) can truly be conducive to structural reform and capacity development. Claessens and Glaessner, from the World Bank, correctly recognize that "liberalization is inexpensive, fast, and easy to implement; building institutional capacity is expensive, slow, and complex."[7] We agree with this assessment, but disagree with the policy implication that the authors draw. They argue that the Bank has a crucial role to play in this effort to build institutional capacity. We agree, but only if the Bank limits its role to that of an institutional facilitator, not an architect. In a sense, the Bank should help transform rent-seekers into profit-seekers and introduce "creative destruction" in the quasi-market.

The World Bank should help local economies make their own choices about institutional development. The Bank can make aid contingent upon the development of institutions that enhance competition in the quasi-market. These institutions, if permitted to function, would allow local entrepreneurs and CPCs to shape the regulatory framework of their economy. Institution-building would be their responsibility, and not the Bank's. With a healthy quasi-market, these activities will better promote economic growth than any aid package from the Bank.

6Buckley (1999, p. 1).

7Claessens and Glaessner (1997, p. 8).

The CPC framework can also be used by the intelligence community to organize its data collection activities in emerging markets. This framework explains *what* data to collect and *how* to organize them. It can therefore readily be applied to many target countries. Beyond the assessment of threat, it would be most useful for the intelligence community to assess the political activities of CPCs. Had this analysis been completed prior to the onset of the crisis, the frailty of Suharto, Inc., would have been made apparent to U.S. policymakers.

Given its unparalleled data-gathering capabilities, the intelligence community can valuably augment the analysis by collecting hard-to-find data—especially data on whom the leaders (or "political entrepreneurs") of the CPCs are, as well as on the complicated interwoven links within and among CPCs, and on the channels of influence they use to accede policymakers. Such information should be of interest to both the State and Treasury Departments in their assessment of the political and economic health of emerging markets. It could also guide USAID in its development aid effort.

Finally, the framework can be used by private multinationals to guide their investment and long-term business strategy in emerging markets. Choosing the "right" business partner is a crucially important decision that is best made with reference to the relative position of CPCs in the economic and political life of the host country. We have used the CPC framework, for example, to advise an oil company with important investment exposure in Indonesia. The analysis allowed identification of key policy indicators that would help the company assess early on the direction of change.

The analysis was also presented to other U.S. and Asian business leaders in commercial satellites and other high-tech industries. These business leaders saw direct application of the methodology to the work done by their strategic planning offices. As for the intelligence community, by explicating what to collect and how to organize the information, the CPC model is directly applicable to their business decisions.

To sum up, the case study should prove particularly helpful to the policy analyst—whether in the public or corporate sector—in replicating the analysis to other countries. The methodology is both fixed and flexible. It is easily replicable in terms

of data collection, analysis, and assessment. Comparisons among several countries in various geographic areas should provide additional interesting insights that a one-country case cannot generate. Although the framework may require some modification and refinement, it seems applicable to the transition economies of the former Soviet bloc, for instance.

AREAS FOR FURTHER RESEARCH

Valuable additional work and research can be done by pursuing the fundamental line of inquiry of the CPC analysis—namely, the study of the economic decisionmaking process in emerging markets, recognizing the important and growing role of CPCs in this process. Three areas for further research stand out.

First and foremost, given the focus on CPCs—i.e., market actors—we have devoted little time to the modeling of government actors and institutions. We have underlined their importance and role, but we have not provided any metrics or criteria to evaluate the exact conditions for the healthy development of a quasi-market for political influence. Further research should provide a list of criteria that would be conducive, as Becker suggests, to efficient policy outcomes instead of inefficient and ultimately destructive outcomes as those generated by the untamed activities of Suharto's kin.

An example of such research could involve a closer look at the role and place of public/private partnerships, organized by the government, in economic policy. Campos and Root have, correctly in our opinion, underscored the role played by deliberation councils in Singapore, Malaysia, Thailand, etc., all cousins of the councils attached to the Japanese Ministry of Trade and Industry (MITI). These councils bring together members of the private and public sector to discuss policy issues. They are very similar to the assembly of merchants of Edward III (see chapter 3 above).

Campos and Root suggest that such councils have allowed East Asian leaders to secure "the support of economic elites without compromising sound policy through mechanisms designed to facilitate consultation, cooperation, and coordination."[8]

8Campos and Root (1996, p. 77).

We share this belief, but the authors do not, as we do, take the analysis further to show that such councils have a limited shelf life. As the economy becomes more complex, it becomes increasingly complicated for a restricted institution to make the correct choices about economic policy. Furthermore, the potential for abuse and corruption cannot be overlooked.

Whereas this study solely used Indonesia as a case study (where such deliberation councils did not formally exist), it would be interesting to compare the activities of these councils across countries and to determine the conditions signaling the end of the councils' usefulness. This could be shown, for example, by looking for instances where economic policy reversed course—and became suddenly more regulatory and cumbersome. For example, in the case of Indonesia, we have mentioned that at the end of 1996, the Indonesian government abruptly ended its outsourcing contract with a Swiss company to perform customs operations. The private Société Générale de Surveillance had been in charge of these operations since 1985—allowing companies to bypass the blatantly corrupt customs bureaucracy. The sudden decision by the government of Indonesia to rescind the contract signaled a clear reversal of the government's commitment to open trade. We believe that the decision stemmed from the desire by some of Suharto's kin to increase the opaqueness of customs operations and thereby creating further rent opportunities. A detailed analysis would help confirm this hypothesis and would probably show how monopolistic the quasi-market had become in order to make such a decision possible. Similar case studies could be done in other emerging markets.

Another interesting line of inquiry would be to use the CPC framework to address in greater detail the issue of the role of government in development—whether it "led" or "followed" the market. With respect to the role of government in enacting regulations, Backer reconciled reality with theory and unified the two apparently contradictory of governments: to work for the common good (by producing public goods and correcting market failures) and to serve the interest of the more powerful (by taxing and subsidizing, hence reducing aggregate efficiency to the benefit of a few). Likewise, the CPC framework reconciles the neoclassical and New Political Economy schools.

Indeed, both schools are correct in their own way. Yes, the neoclassical economists are right to argue that East Asian economies have been successful because of the

hands-off approach of governments, which allowed private market actors to better allocate scarce resources. At the same time, the NPE scholars are right to argue that private market actors responded to incentives established by governments. These incentives were of two kinds: (1) the promotion of a healthy quasi-market by providing the rule of law, and allowing business interests to coalesce as they saw fit; and (2) the steering of private and public investment to "strategic" industries through preferential treatment. Whereas the former policies were efficiency-enhancing, the latter policies were not, since they created artificially monopolistic conditions and attracted rent-seekers. A closer look at these arguments, using the CPC framework would reveal, we believe, valuable insights about the issue of the role of government in economic development.

A second interesting line of inquiry for future work would be to try to better identify the "political entrepreneurs" of CPCs. Similarly, more work should be done in trying to understand the complex links within and among CPCs. This "Kremlinology" of CPCs would allow the analyst to identify policy levers (people or organizations) that could be targeted. For example, a meeting with the leader of a CPC could help transmit the concerns of the U.S. government related to the nefarious consequences of a CPC's rent-seeking activities. More precisely, it would have been useful to have told Suharto or some of his family members that their zeal in trying to get a share of every foreign broker's profit (generating from the underwriting of public offerings of state assets) would ultimately lead to the brokers' withdrawal from underwriting Indonesian equity, hence jeopardizing the prospects for privatization. If such a meeting proved inconsequential, withdrawal of aid may have helped discipline the CPCs.

The third line of research would seek to place the CPC analysis in a dynamic context. Most of the CPC analysis in this study has been static. We have tried to offer some historical perspective on the evolution of the role and influence of CPCs on economic policy, but more work should be done in this area. In the context of regulation, both Olson and Becker suggest that, as time elapses, regulations increase in complexity and irrelevance (because they are being circumvented). Time may be an independent variable with high explanatory power in any dynamic model of the quasi-market for political influence. It can also be one of the driving forces behind the major shocks that seem to hit emerging markets every few years. Boom and bust

cycles may be partly explained by the paralyzing effects of inadequate regulation and the political activities undertaken by CPCs to try to circumvent them, instead of seeking out productive investments for their scarce resources.

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